ECONOMICS OF BANKING TRADE, AND FINANCE

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PREFACE

THIS book is intended to be used in conjunction with our *Economics of Production and Exchange* in order that jointly they may provide, within reasonable compass, a general survey of the principles of economic theory. In a work of this character, covering such a wide field, it is obvious that exhaustive treatment of any part of the subject-matter is out of the question. We have, therefore, aimed at a method of treatment which we trust will assist the student in developing a general background of knowledge in connection with this very important branch of economic science, and at the same time have indicated, by numerous quotations, some of the best sources for more specialized study. Incidentally, it is hoped that the book may prove of interest, not only to those who are working for examinations, but also to the general reader.

The publication of the Report of the Committee on Finance and Industry followed by the Minutes of Evidence has provided a rich source of information on many aspects of the British financial system. Of equal importance in their own sphere are the reports which have been produced by the Gold Delegation of the League of Nations. In addition, the monetary crisis has provoked a flood of literature—authoritative and otherwise—bearing on the various different aspects of trade and finance. An attempt has been made, on the basis of these contributions, to provide an accurate view of the system of trade and finance as it exists at the present day, and to examine some of its outstanding problems. Yet, at the same time it must be remembered that although a knowledge of contemporary events is essential to the student, it is even more important that he should grasp the principles which are at work causing those developments. Hence we have sought to elucidate general principles and illustrate their operation by reference to recent events.

It is hoped that the book will be of assistance to those preparing for examinations in Economics and Banking in connection with the various universities and professional bodies, such as those of the University of London, the Accountancy and Secretarial examinations, and examinations conducted by the Royal Society of Arts,

the Institute of Bankers, the London Chamber of Commerce, the Union of Lancashire and Cheshire Institutes, the National Union of Teachers, the Northern Counties Technical Examinations Council, and similar bodies.

Finally, we desire to express our thanks to all those who have in any way assisted us in our work, and particularly to Marjorie G. Stephenson and Olwen H. Davies for assistance in the preparation of the manuscript for press.

JAMES STEPHENSON.
NOEL BRANTON.

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CHAPTER I

INFLUENCE OF MONEY ON PRICES

THE expression "value of money" is one which is employed in a variety of ways in the business world, but for our purpose in this chapter we shall use it to refer to the ability of money to command other goods in exchange. In speaking of the value of money, we are confronted by a difficulty which does not arise in the case of other economic goods. We have spoken of value as a ratio—the relative quantities of one commodity which will exchange for another—so that logically no difficulty should arise. Yet, for practical purposes, we have adopted money as a kind of permanent term in this ratio, so that the values of all economic goods are expressed in terms of money, with the result that when we come to study the value of money itself, we experience a sense of confusion. We are led to inquire what commodity shall we use for the purpose of comparison, since obviously we cannot express the value of money in terms of money.

In order to achieve our purpose, we must, therefore, free ourselves from these customary ideas and reverse the usual process—we must compare money with some other commodity or commodities. At the outset, however, we find ourselves confronted by further perplexities. Let us assume that we decide to measure changes in the value of money in terms of wool, and that in January wool was valued at 15d. per lb., whilst in February it was valued at 30d In February, therefore, 15d. would buy only half a pound of wool, so that between the two dates money, expressed in terms of wool, would have fallen in value by 50 per cent. But an examination of the market reports on raw materials shows that the values of commodities are subject to variation in different directions, so that it is quite possible for cotton to have varied from 15d. per lb. to 10d.

Measuring the value of money in terms of cotton, we find that it has risen by 33⅓ per cent in the same period. For our purpose, therefore, such comparisons as these are of little value, and the variations which we have noted are due more to fluctuations in the economic value of the wool and cotton rather than to changes in the value of money itself.

Money may be said to represent generalized purchasing power, so that, in order to estimate changes in its value, we must compare it with commodities in general, and not with one or with a limited group of articles. Now, if all prices went up and down together, the problem of measurement would be simplified considerably, but, as we know, the prices of different commodities vary in their movements over a given period of time, some rising, others falling, whilst others, again, remain steady. Even in times of trade boom or depression, when prices in general show a disposition to move upwards or downwards, there are still wide variations in the amplitude of their movements. Hence, all that we can do is to strike an average in some way or other which will indicate in what direction, if any, the value of money is changing. In the words of Professor Cannan—

> Commodities and services are so numerous in kind, and the kinds shade into each other so gradually, that to take into account the price of all of them is much like taking into account the level of every part of a rough field, when smoothing it is not to be thought of. We cannot do it literally, and must be content with taking a sufficient number of measurements at points selected without bias.

In order to gain this information as to the general trend of prices a statistical device is employed, known as an *index number*. Index numbers assumed considerable importance in recent years, so that we must at this point consider them in greater detail.

MEASURING THE VALUE OF MONEY. When we speak of the value of money or of the general level of prices, we are referring to what is essentially the same thing regarded from two different angles. If the value of the monetary unit falls, it will obviously command fewer commodities and services than was formerly the case. In other words, a given commodity will exchange for a greater quantity of money, so that we say its price has risen. In reality, therefore, a fall in the value of money is the same thing as a rise in the level of prices and, conversely, a rise in the value of money is marked by a

fall in the level of prices. An index number provides us with a device for ascertaining the average change in the prices of a number of commodities. Prices are quoted in all kinds of denominations: bread per quartern; wheat per bushel, coal per ton; cotton per pound; and cattle per head. Such quotations are incomparable with one another, and the index number serves to reduce them to a common basis.

Now, index numbers exist in great variety for a number of different purposes, and, although they constitute a valuable means of economic investigation when properly employed, they can become very misleading if applied to problems for which they were never designed. In selecting an index number, therefore, consideration should be given to the following points—

1. Purpose of the Index Number. The same index could not be employed to reveal changes in the general level of prices, and changes in the cost of living. These two objects are so different that no one index could ever cover both. Again, although we employ a single index, such as the Ministry of Labour Index, to show fluctuations of the cost of living in general, this is at best a rough approximation, since standards of living vary between one class and another, and between sections of the *same* class located in different places. Hence, before selecting an index, we should carefully consider the nature of the problem to which we intend to apply it.

2. The Mathematical Formula. An index number is essentially an average, but of these the statistician has many types, such as the arithmetic mean, the geometric mean, the harmonic mean, and the median; whilst he has employed his ingenuity to combine these in numerous complex formulae for different purposes. From this confusing array, the investigator must select that formula which he considers will best answer his purpose.

3. Choice of Commodities. The next difficulty which must be solved is the selection of the commodities whose price is to be incorporated in the index formula, since it is clearly impossible to include the prices of all commodities. Thus, it will be necessary to decide whether the index for the general price level shall take into account wholesale prices only, or whether it shall cover retail prices, wages, rents, transferable securities, etc. In compiling an index to show changes in the value of money, wholesale prices are usually employed.

The reason for this procedure lies in the fact that, for purposes of comparison over a long period of years, it is essential that the grade of the commodities employed should be definable and not subject to frequent change—a condition which is best satisfied by the primary products quoted on the wholesale markets On the other hand, finished products, sold at retail, exist in a great variety of grades and classes, and are liable to frequent and rapid changes of quality in response to the caprices of public demand. Hence, without elaborate descriptions, it is difficult to be sure that prices quoted at different times are really the prices of exactly the same thing.

4. Weighting. The next problem is to decide what measure of importance shall be attached to each price in the index formula. It is, for example, quite obvious that greater importance should be attached to variations in wheat or iron ore prices than to fluctuations in the cost of pepper. This is overcome by the mathematical device known as weighting—a process whereby the average price of each commodity is multiplied by a number indicative of its estimated comparative importance as measured by the relative quantities consumed. Many index numbers are weighted by increasing the number of quotations for an important commodity and giving only a single quotation for an unimportant one.

5. The Base Period. Changes must be measured as a relative value, and for this reason we must take the prices prevailing in a particular year as the standard and compare all others with these. It has become customary in many economic comparisons to take 1913 as this base year, but there is no particular object in so doing, except in so far as it is the last year before the Great War, with its abnormal economic conditions. It is employed in the Board of Trade Wholesale Price Index, but the *Economist* Index is now calculated on 1927 as the base year

As a simple illustration, let us suppose that we construct an index of four commodities, A, B, C, and D for the purpose of measuring variations in the general level of prices. The base year selected for comparison is 1913, and a simple arithmetical average is employed, whilst each commodity is deemed to be of equal importance. The price of each commodity is obtained for the base year and for the year 1931, which is under investigation. Each individual price in 1913 is represented by 100, so that the total of

the group in that year is 400, and the index, taking the arithmetical average, is $\frac{400}{4}$, or 100. The price of each commodity in 1931 is now expressed as a percentage of the price in 1913, thus obtaining an index for each individual commodity. For example, commodity A is represented by $\frac{12}{10} \times 100$, or 120, and the index for each commodity is calculated on similar lines. The arithmetic average of the group is 109, which represents the increased general level of prices in 1931 as compared with 1913.[1]

Commodity	1913		1931	
	Price	Index	Price	Index
A	10s.	100	12s.	120
B	4s.	100	5s.	125
C	9s.	100	6s.	66
D	8s.	100	10s.	125
		400		436
	Index $= \frac{400}{4} = 100$		$\frac{436}{4} = 109$	

THE VALUE OF MONEY. When dealing with the values of commodities in general, we know that they are the product of the interaction of two forces—the supply of the commodity in question and the demand for it—and that in the long period this value must bear some relationship to costs of production. Money itself is but one form of economic goods, and if this point is clearly kept in mind in the course of the following pages, it will assist considerably in the comprehension of the theory of the value of money. Now, when a country maintains a full gold standard, that is, where gold is freely coined at the Mint and circulates in the community for the settlement of debts, it is evident that there can be no divergence between the value of gold and the value of the country's

[1] In an introductory work of this nature it is not possible to discuss index numbers in any detail. The reader who desires further information should consult a good textbook on Statistics, such as Professor A. L. Bowley's *Elements of Statistics*, or Professor Irving Fisher's *Making of an Index Number*.

money. A given weight of bullion is convertible into the same weigh of coin and *vice versa*, and the mere fact that the two continue t exist side by side is proof that they are of equal value, weight fo weight At this point, however, a word of caution is necessary Although the value of money *in terms of gold* remains constant, w must not fall into the error of imagining that the value of money i therefore invariable, since the value of gold expressed in terms o other commodities is liable to variation.

When gold is employed as a money material in this way, it derives its value from two sources. In the first place, it is desired as an article of consumption for use in the arts and for purposes of adornment, whilst, in addition, it is in demand because of its use as money. In the first of these functions it possesses direct utility, but in the second its utility is indirect, inasmuch as it cannot be realized until the money is spent. Hence, gold may be desired both for its own sake and as representative wealth—as the power to command the goods and services of other people. When, therefore, the unit of account is a fixed quantity of bullion, whether it be gold or any other of the precious metals, its value is determined in a way similar to that of any other economic good.

The value of a precious metal is dependent on just the same things as the value of any other metal. If more people demand it (that is, want it and have means to pay for it), or if the same number of persons demand more, it will rise in value and *vice versa*. If more persons are willing and able to produce it, or if the persons already engaged in its production are able and willing to produce more of it, its value will tend to fall.[1]

At the outset, in order to simplify the discussion, let us assume that metallic money only is in circulation within a country. The demand for money in such a case will depend upon the number of persons and institutions, such as banks and business houses, which need separate holdings of coin, and also upon the magnitude of each holding. In the first place, therefore, the demand for money will be increased by an expansion of population, or, at all events, by an expansion of that portion of the population which requires a stock of money for everyday purposes. In a modern community, as we have already shown elsewhere,[2] every person with resources at his disposal needs some means whereby he can employ them

[1] *Money*, Professor Edwin Cannan.

[2] *Economics of Production and Exchange*, by James Stephenson and Noel Branton.

to obtain goods and services from other persons. The colliery proprietor would satisfy his domestic needs with difficulty were he compelled to give coal in exchange for his other requirements, so that for the sake of convenience he must hold part of his resources in the form of money, which represents generalized purchasing power. Every member of the community who requires to command the goods and services of others must do likewise, and the sum total of these separate holdings constitutes one aspect of the demand for money.

The second aspect is the magnitude of each individual holding, and this will vary with personal customs and needs. The magnitude of each holding will depend upon the income of the holder and the frequency with which he is paid, whilst it will also vary according to his method of dealing—whether for cash or on credit. To quote Professor Cannan—

> Before the introduction of paper currencies and methods of setting one payment against another provided by such machinery as bills of exchange and banks, the magnitude of the want for these stocks of coin must have depended largely on the amounts of money which the holder had to spend in the year, and on the length of the periods for which payments such as rent and wages were made. . . . supposing a custom came in of paying rents only twice a year instead of four times, both the landlord and the farmer would have to keep more coin by them on the average, and if weekly wages became the custom in place of fortnightly, both employers and workmen would have to keep less by them on the average, as their stocks would be replenished more frequently.

Again, looking at the question from the standpoint of the business undertaking, care is always taken to maintain a certain proportion of the assets of a business in the form of cash. The magnitude of this holding of cash will vary according to the anticipated demand for payment from suppliers and according to the magnitude of current disbursements for the wages and salaries of the staff, as well as other expenses such as rates and taxes. The cash reserve will be such as is estimated to cover these requirements, together with such a margin for unforeseen contingencies as the experience or the prudence of the management dictates. The object at all times will be to hold a sufficient, but not excessive, cash reserve, since if this be too great it merely sterilizes resources which might be more profitably employed. Such considerations will prevail with business undertakings and private individuals alike.

The magnitude of a person's holding of coin will, from the standpoint of the theory of value, be such as to secure equi-marginal utility from every use to which he wishes to apply it. Money may be devoted to a number of uses, such as the purchase of commodities for consumption, investment in securities of various kinds, and, as stated above, as a reserve for security and convenience. A man will apply his money income to these competing uses in such a way as to obtain the same marginal utility from each, so that the magnitude of his holding of cash will be determined as the result of a mental process of "weighing up" the convenience afforded by the possession of coin as against the utilities arising from its expenditure or investment. In the words of Lavington, in his book *The English Capital Market*—

> Resources devoted to consumption supply an income of immediate satisfaction; those held as a stock of currency yield a return of convenience and security; those devoted to investment in the narrower sense of the term yield a return in the form of interest In so far, therefore, as his judgment gives effect to his self-interest, the quantity of resources which he holds in the form of money will be such that the unit of resources which is just and only just worth while holding in this form yields him a return of convenience and security equal to the yield of satisfaction derived from the marginal unit spent on consumables, and equal also to the net rate of interest

Approaching the problem of the value of a metallic currency from the side of supply, we may use the term to denote the total stock of the precious metal in a country. In the case of the majority of economic goods we regard the supply as a continuous stream rather than as a reservoir. But gold, which now acts as the standard in the Western world, belongs to a class of goods—usually termed instrumental goods—the consumption of which is very slow, so that, by dint of accumulation, the available stock has become very large and the annual increment, being small in comparison, makes very little difference. The annual production of gold makes approximately an addition of some 2 per cent to the existing stock. The stock or "supply" of gold coin may be diminished by wear and tear or by withdrawal from circulation through hoarding, whilst it may also be reduced by diversion to other uses, such as the melting down of coin for use as ornaments and for decorative purposes.

Conversely, it is possible for the supply of gold for monetary purposes to be increased by diversion from industrial and other

uses. Large quantities of gold are in the hands of the public, more especially in India, in the form of gold ornaments and private hoards. There is no evidence, however, that gold flows in any large quantity from non-monetary sources to monetary reserves except during times of war. To all intents and purposes, therefore, the stock can be increased only by the annual production of gold from the mines, and this will take place in accordance with the laws which govern the production of any other type of economic good.

There is a tendency, as Professor Cannan points out, for people to imagine that cost of production has little or nothing to do with the value of gold. Yet, cost of production exerts a similar influence on gold production as it does in the case of any other commodity. Gold mining, as an extractive industry, tends to work at an increasing cost per unit of output. Only those mines in which the cost of production is smaller than, or equal to, the market value will be worked. Every sixpence increase in the cost per ton of gold ore milled represents a reduction of many thousands of tons of ore in the total tonnage available for extraction, as the rise in the cost of production cannot be added to the sale price of gold. The causes which may produce such a rise in costs are numerous, ranging from an increase in the cost of stores and heavy railway rates to excessive pay of employees and inefficient management. Owing to the exhaustion of payable ore in the upper levels of most mines, the depth of the mine workings is continually increasing, and is thereby not only adding to the working costs, but also giving rise to new problems of mining. If the price level continues unaltered, the increase in productive costs due to these causes will bring about the elimination of producers working under the least favourable conditions. A rise in the price level, indicating a fall in the value of gold, will produce the same result. Conversely, a fall in the general level of prices will tend to decrease working costs and enable producers to operate the poorer mines at a profit.

So far we have considered the value of money where the unit of account is a fixed quantity of bullion. We now have to turn our attention to the problems which arise when the unit of account is a paper note, which may or may not be convertible into the amount of bullion which it is supposed to represent. When the notes issued are convertible into a specified amount of bullion, whether coined

or otherwise, which may be exported at the option of the holder, then the value of the notes can never deviate from that of the bullion into which they are convertible. Nevertheless, an issue of redeemable notes circulating at par with coin may, by causing a reduction in the demand for coinage, diminish the value of bullion and cause a rise in prices. It cannot be assumed, however, that an issue of notes will displace an equal amount of metallic coinage from circulation. When coin only is in circulation, people tend to keep down their holdings of it to a minimum in view of its inconvenient bulk. When an issue of notes is made in addition to the coin, people are impressed by the greater convenience of the new money, and will be inclined to hold larger proportions of their income in the form of cash. Hence the depressing effect of a convertible paper currency upon the value of bullion may be offset by an increase in the demand for currency.

An inconvertible note issue, that is, an issue which cannot be exchanged for bullion, has far greater potentialities for depressing the value of the unit of account and raising prices. It is possible, of course, for such a currency to circulate at the same value as that of an equivalent amount of bullion, provided that moderation is exercised when issuing, and that confidence in the good faith of the Government is sufficiently strong. Unfortunately, the history of paper currencies on an inconvertible basis is marked by no such moderation, and notes are usually issued in such volume that their value bears but a remote correspondence with their face value in terms of bullion.

When the issuers of inconvertible notes or notes which are only convertible into inconvertible coin issue them so freely that they will exchange for less than the par amount of bullion, when, that is, in other words, the price of bullion rises above the par price, so that the note will no longer buy raw material for the coin which the note represents, the unit of account ceases to be a coin or quantity of metal, and becomes a printed symbol on a piece of paper the supply of which depends on the moderation of the issuers.[1]

Failure to exercise this spirit of moderation shakes the confidence of the public in the currency and causes a diminution in the demand for it. There is a fear that payments in bullion will never be resumed, or that resumption will take place on a depreciated basis. This causes the holders of such currency to hesitate to hold it and to

[1] *Money*, Professor Edwin Cannan

offer it in larger quantities in payment for goods. On the other hand, owners of goods are less anxious to dispose of them for money and require larger quantities of it in order to induce them to exchange Hence, the diminution in demand for the notes is as potent a cause in the fall in their value as the increase in the supply.

QUANTITY THEORY OF MONEY. Although a number of theories have been put forward to explain the value of money, the one which has the widest acceptance at the present day is the Quantity Theory, though it is true that there exist differences of opinion as to the way in which the theory should be stated. Expressed briefly, the theory may be enunciated as follows: Other conditions remaining equal, every increase in the quantity of money in circulation causes an exactly proportional increase in the general level of prices. Probably the most complete exposition of this theory is to be found in Professor Irving Fisher's *Purchasing Power of Money*. "Apart from the influence of deposit currency or cheques," says Fisher, "the price level may be said to depend on only three sets of causes—

"(1) the quantity of money in circulation;

"(2) its 'efficiency' or velocity of circulation (or the average number of times a year money is exchanged for goods); and

"(3) the volume of trade (or amount of goods bought by money)."

The first of these propositions, namely, that the price level varies with the quantity of money, is declared to be fundamental to the theory.

The quantity theory asserts that (provided velocity of circulation and volume of trade are unchanged) if we increase the *number* of dollars, whether by renaming coins, or by debasing coins, or by increased coinage, or by any other means, prices will be increased in the same proportion. It is the number and not the weight that is essential. This fact needs great emphasis. It is a fact which differentiates money from all other goods, and emphasizes the peculiar manner in which its purchasing power is related to other goods. Sugar, for instance, has a specific desirability dependent on its quantity in pounds Money has no such quality. The value of sugar depends on its *actual quantity*. If the quantity of sugar is changed from 1,000,000 pounds to 1,000,000 hundredweights, it does not follow that a hundredweight will have the value previously possessed by a pound. But if money in circulation is changed from 1,000,000 units of one weight to 1,000,000 units of another weight, the value of each unit will remain unchanged.

The Quantity Theory can best be explained by reference to what is termed the equation of exchange. This is a statement in mathematical form of the total transactions effected in a certain period in a given community. It is simply the sum of the equations involved in all individual exchanges in a year. Adopting the form employed by Fisher, let us represent the total annual expenditure on commodities in any community by E, whilst the average amount of money in circulation is M. Now, this "average amount" of money which is in circulation is far from being equivalent to E, the total expenditure, so that, in order that it may do the requisite amount of work, the same monetary units must be used a number of times We may, therefore, derive a ratio of E to M, that is, the relation between annual expenditure and the amount of money, and this ratio is the average rate of turnover of money, or, more commonly, its velocity of circulation This concept has been defined as the ratio of the amount of money expended to the average money on hand, so that, if it is represented by V, we may say that

$$V = \frac{E}{M} \text{ or } E = VM.$$

Putting this latter equation into words, we may say that the total expenditure of money on goods within a given period of time is equal to the product of the average amount of money and its velocity of circulation. So much for the "money" side of the equation of exchange: we must now turn our attention to what is known as the "goods" side. Let us suppose that the average price of a particular commodity, say wheat, within the period is represented by p, whilst the total quantity purchased in the same period is represented by q. Then the total expenditure on that commodity in the time under review is represented by the product of these two factors, namely, pq. But any number of commodities enter into exchange at varying prices and in varying quantities. Let us, therefore, designate the average price of each by p^1, p^2, p^3, etc., and the total quantity taken by q^1, q^2, q^3, etc. Hence, the total expenditure on each will be p^1q^1, p^2q^2, p^3q^3, etc. Obviously the total expenditure on commodities of all kinds in the period is represented by the sum of the amounts expended on individual commodities, so

that the expenditure may be represented in algebraic form as follows—

$$pq + p^1q^1 + p^2q^2 + p^3q^3 + \ldots p^nq^n$$

or, employing Σ as a symbol of summation, Σpq. But the "money" side and the "goods" side of the equation of exchange are equal to one another, so that we may say

$$VM = \Sigma pq$$

or, more generally, $VM = PT$

where P is the weighted average of all the different commodity prices and, therefore, represents what is termed the general price level, and T is the total volume of trade effected, that is, the aggregate of goods which have been exchanged against money in the course of the period under survey.

So far we have confined our attention to that class of circulating media which Fisher terms "real money," and have left out of consideration bank deposits which are transferred by cheque. Now, in a modern community an enormous volume of transactions are settled by the use of credit instruments of one kind and another, so that if the above equation is to be brought into relation with fact, it must give due weight to this circumstance. Fisher, therefore, extends his original equation and gives it in the form

$$PT = MV + M^1V^1$$

or

$$P = \frac{MV + M^1V^1}{T}$$

where M^1 represents the amount of bank deposits transferred by cheque and V^1 their average velocity of circulation. He does not include credit instruments other than cheques, such as bills of exchange and book credits, on the ground that these have no influence on the price level, since they merely postpone and do not dispense with the use of money. This argument is difficult to maintain, since the cheque and the bill of exchange are only variations of the same credit instrument.

The theory thus formulated now requires another qualification. The validity of the above equation rests upon the assumption that M^1, the volume of bank deposits, bears a fairly constant ratio to M, the quantity of money in circulation, for unless a change in one of

these quantities calls forth a corresponding alteration in the other, the whole relationship is disturbed. Fisher assumes that there is such a constant relationship in the long run, and justifies this contention upon the following grounds—

> Two facts normally give deposits a more or less definite ratio to money. The first . . . that bank reserves are kept in a more or less definite ratio to bank deposits The second is that individual firms and corporations preserve more or less definite ratios between their cash transactions and their cheque transactions, and also between their money and deposit balances. These ratios are determined by motives of individual convenience and habit.

He does acknowledge, however, that the relation between the quantities is disturbed in transitional periods, so that the equation does not represent the true position until stability is once more obtained. Nevertheless, it would appear to be an unjustified assumption to speak of a fixed ratio of cash to bank deposits, since custom and convenience, as well as the exigencies of the moment, will all tend to exert an influence in this matter.

Mr. J. M. Keynes, in his *Tract on Monetary Reform*, sets forth an alternative formula for the equation of exchange. The holdings of cash in the hands of the public are represented by an amount of money which will purchase *k consumption units*. This latter term is defined as " a collection of specified quantities of standard articles of consumption or other objects of expenditure," such as the types and amounts of goods which are found in a cost of living index number. If n be the number of units of currency in circulation, whilst p is the price of each consumption unit, then on the same lines as before—

$$n = pk.$$

Extending the equation to bank deposits, we may assume that the public holds the equivalent of k^1 consumption units in this form, and that the customary bank ratio of cash to potential liabilities is r. Then the equation of exchange will assume the form

$$n = p\ (k + k^1r).$$

So long as the expression $(k + k^1r)$ remains unchanged, then we have a direct relationship between the quantity of money in circulation and the level of prices. As Mr. Keynes points out, however, we cannot in practice make this assumption, since a change in the

quantity of money (n) is liable to react on the values of k, k^1, and r. Thus, he says—

> In agricultural countries where peasants readily hoard money, an inflation, especially in its early stages, does not raise prices proportionately, because when, as a result of a certain rise in the price of agricultural products, more money flows into the pockets of the peasants, it tends to stick there; deeming themselves that much richer, the peasants increase the proportion of their receipts that they hoard.

Hence, there is a certain friction which tends to promote the stability of the price level in the face of changes in the volume of money in circulation There is no fundamental difference between these two equations and transition from one to the other is fairly easy

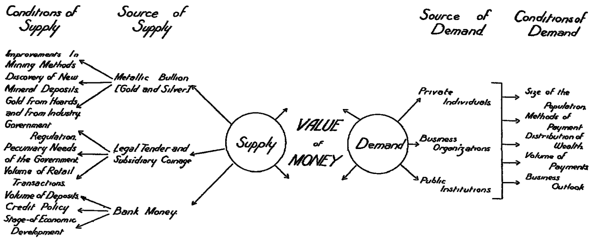
Again, the "velocity of circulation" of money which is referred to by Fisher in his statement of the Quantity Theory, has been criticized by Professor Cannan. As we have already pointed out in our discussion of the factors which influence the value of money, the supply of money may be regarded as the existing stock rather than the annual output. Arising from this fact, the demand for money may be said to be the result of the desire which people have to *hold* money rather than to *consume it*. This is a very different conception from that which considers that the demand for money is furnished by the number and amount of transactions carried through by it. In this connection, Professor Cannan says—

> That belief seems to me to be exactly equal to a belief that the demand for houses comes not from the people who want to live in houses, but from people who buy houses and sell them again forthwith. The effective demand for houses evidently comes from those who want to *hold* houses: even the speculator wants to hold for a time. Mere "activity in the house market"—a little more changing ownership than usual—only involves an increase in demand in the same sense as it involves an equal increase of supply which cancels it Whatever may be said about the actual use of the terms, it is clear that the demand which is important as affecting the value of the houses is the demand for occupation

Following up the argument, the same writer goes on to examine the principal factors which create changes in demand. These may be summarized as follows—

Changes in Population. By increasing or diminishing the number of persons requiring a holding of money, the demand for currency changes accordingly.

THE VALUE OF MONEY AND ITS DETERMINATION



The value of money is determined, in common with that of all other commodities, by the interaction of supply and demand. The supply of moneyi n a developed commercial community may consist of gold or silver bullion, legal tender currency, subsidiary coinage, and bank money (e g cheques, bills of exchange, bank loans, and overdrafts) The supply of bullion for monetary purposes depends upon the technical efficiency of mining methods and the discovery of new sources of supply. Additional supplies may also be obtained by diversion of metal from industrial uses and from hoards. In regard to the second type of money, the supply will depend on the regulations of the government, which may often depend upon its own needs The volume of bank money will depend upon the magnitude of the deposits lodged with the banks and the credit policy which they pursue in regard to these deposits It will also depend upon the stage of economic development of the community which will determine the extent of the employment of bank money

The demand for money comes from private individuals and institutions who desire holdings of cash. The demand for money will depend upon the size of the population and upon the number of payments which have to be made It will also depend upon the manner in which wealth is distributed amongst individuals Finally the future business outlook will determine to some extent whether resources will be held in the form of cash or be invested in other forms of economic wealth.

Economies in Currency. The discovery of new machinery for dispensing with money in the settlement of transactions may reduce the demand for currency and so cause a rise in prices.

Changes in the Distribution of Wealth. A more equal distribution of wealth amongst the poorer classes of the population will tend to find reflection in an increase in the average size of their holdings of cash.

Psychological Causes. People, in attempting to forecast the trend of events in the future, are apt to make errors, and these mistakes tend to be in the same direction throughout a community. An expectation of falling prices will produce a desire to hold money in preference to other commodities, and this in itself will cause the value of money to appreciate.

Yet another point which should be noted in connection with the equation of exchange is the importance of the element of time. The equation is valid only when the factors composing it are considered over a sufficiently long period of time, such as, for example, one year. It is quite useless when applied to a given moment of time, or even to a period which is far too short. Thus, in his work *Business Cycles*, Dr. Wesley C Mitchell observes that—

> The three quantities represented in the equation of exchange as simultaneous—payments, prices, and physical volume of trade—are, in fact, three stages through which business transactions pass in time. When a sale is made, the parties agree, tacitly or explicitly, upon the price, upon the quantity of goods to be transferred, upon the date of delivery, and upon the date when payment is due In the retail trade, all three stages are frequently completed in a few minutes—the customer assents to the price, receives his bundle, and pays cash But delivery is deferred when consumers' goods are made to order, and payment is often deferred to the end of the month, or spread over several months on some "instalment plan." In wholesale trade, weeks or months commonly elapse between the date when a sale is made at an agreed-upon price, and the date when the goods are delivered to the buyer, and the still later date when the seller receives a cheque.

In other words, there is a more or less protracted time lag in the sequence of the stages of every business transaction, the duration of the complete cycle depending upon the class of business and the nature of the trade. Hence, in studying the relations between the factors which compose the equation of exchange, the time element must be given due weight if the statement is to have any value. If we examine Professor Fisher's equation $PT = MV + M^1V^1$,

having due regard to this element of time, we find that on a day-to-day basis the relations between the two sides of the equation are indeterminate. Thus, the payments made on any given day, to a considerable extent, will be in respect of goods and services (*T*) which have changed hands weeks, or perhaps months, before. The prices (*P*) which are paid for them were fixed at a date still earlier. We can overcome these difficulties only by considering the factors in the equation over a sufficiently long period of time—say, one year In such circumstances we are justified in the assumption that payments, prices, and transfers of goods refer approximately to the period taken, and that the equation holds good.

FLUCTUATION IN PRICES. From the foregoing theoretical examination it will be seen that there is a relationship between the volume of production, the quantity of money in circulation, and the value of money, or, as we usually say, the general level of prices. If, therefore, the issue of money and credit remains constant, whilst the volume of production remains unchanged, we may expect to have stability in the price level. So great is the complexity of modern life, however, that it would be an utter impossibility to preserve this static condition even if it were desirable. The tendency of the world in general is for the production of goods to show a steady rate of increase, which has been computed at roughly 3 per cent per annum, though, of course, individual countries show wide variations from this average. Assuming, however, that such an increase does take place in a particular country, and that the volume of its currency remains unaltered, then the same amount of money will purchase this larger quantity of goods, so that the general level of prices will fall. Conversely, a diminution of production will result in a rise in prices, provided that the volume of currency remains unchanged. In such circumstances, if the general level of commodity prices is to remain stable, an increase of production, involving as it does an increased turnover of goods and services, calls for a corresponding increase in the amount of money and credit to effect this turnover. On the other hand, an increase or a decrease in the quantity of money available, unaccompanied by any corresponding change in the volume of production, will produce fluctuations in the level of prices

So far as the internal affairs of a community are concerned, the

PRICE FLUCTUATIONS AND THEIR EFFECTS

Section Affected	Rising Prices	Falling Prices
Investing Class .	Those having incomes from fixed-interest securities find that the purchasing power of the yield from them becomes smaller. There is a check in the investment in such securities.	Incomes derived from these sources remain unaltered in terms of money, but their purchasing power shows a proportionate increase. The rate of interest on new loans will fall.
Entrepreneur Class .	(1) There is an appreciation in the value of industrial stocks and plant. (2) The margin of profit becomes greater. (3) Industrial and commercial enterprise is stimulated.	(1) Profits diminish owing to a fall in turnover combined with a failure to adjust expenses. (2) New capital can be raised only with difficulty on account of the low yields on ordinary shares. (3) Stocks accumulate and have to be liquidated at a loss.
Wage-earning Class.	(1) Prices tend to rise faster than advances in wages can be secured and the standard of living is threatened. (2) Employment is good in all branches of industry. (3) There is an extension of consumer demand owing to the greater volume of purchasing power.	(1) Wages fall more slowly than prices on account of resistance offered by trade unions and the lag in retail prices. The standard of living tends to improve. (2) Employment is bad and there is much short-time working. (3) The unsheltered export trades suffer more than the sheltered industries.
The State . .	(1) The money revenue of the State increases with the boom in trade although its purchasing power will not increase in proportion (2) Increased taxation will be necessary, but the burden on the taxpayer is not so heavy. (3) The burden of the national debt is reduced. (4) Public expenditure in all its branches tends to increase.	(1) Revenue tends to decline in all its branches. (2) Expenditure on social services may be increased, e g. unemployment relief. (3) The burden of the national debt increases and can be reduced only by conversion. (4) The weight of taxation presses heavily on industry and there is a demand for the reduction of public expenditure.

level of prices is a matter of small concern, provided that it is stable. Relative values remain unchanged when each individual value is multiplied by a common factor. If prices were doubled, and the amount of currency in the possession of each individual increased in the same proportion, the relative position of the different members of the community would not be changed—no one would be better or worse off. This is, of course, disregarding all effects on external trade with other countries where relative price levels are of considerable importance. The evil effects occur in the period of transition, when the relative economic status and welfare of different sections of the community are profoundly affected. We shall now attempt a brief examination of these effects.

As already indicated, under the complex conditions prevailing in the modern world, all the stages of a business transaction are rarely completed at one time. In the majority of cases they involve contracts, expressed in terms of money, their settlement being deferred over widely varying periods of time. Let us assume that there is a fall of 20 per cent in the general level of prices, so that the purchasing power of money rises, in effect, by 25 per cent. In this case, all debtors in the community, when settling their predetermined obligations in terms of money, will be compelled to give to their creditors a title to goods 25 per cent greater than was bargained for in the contract. Yet, owing to what Professor Fisher terms the "money illusion"—the tendency which the majority of people have to regard money as something fixed and invariable—there will be no general realization of what has happened. The national income as a whole has to be divided between the debtor and creditor sections of the community in different proportions from those ruling before But, as production increases only slowly and the creditor class is able to buy more goods with the same sum of money, it follows that the debtor class must buy less

Mr. Keynes, in his *Tract on Monetary Reform*, in dealing with the effects of changes in the value of money, divides the community up into three classes—the investing class, the business class, and the earning class. Although these are not mutually exclusive, they form a convenient basis for discussion. A member of the investing or *rentier* class is one who has "parted with his real property permanently, in return either for a perpetual annuity fixed in terms of

money, or for a terminable annuity and the repayment of the principal in money at the end of the term, as typified by mortgages, bonds, debentures, and preference shares." A fall in the general level of prices increases automatically the share of the national income which falls to the lot of this class and, in the absence of any increase of production, reduces the share available to the remaining two classes. The claims of this class arise mainly from their holdings of the National Debt, the mortgages and debentures of public and private undertakings, and also for rent on landed and house property. In the first case—the service and redemption of the public debt—production as a whole will feel the burden of taxation pressing more heavily upon it, since the sums payable remain constant in monetary expression but have a much greater purchasing power. Similarly, in the case of mortgage and debenture interest, the individual business has to pay away a greater share of its income in satisfaction of its bondholders In the latter case, of course, the strain is felt most by those concerns having the greatest fixed charges.

Coming now to the second class—the business or entrepreneur class—we find that the immediate burden of falling prices tends to press most heavily upon this section of the community. In the first place, the fall in prices reduces the gross income of the business undertaking, it being assumed that this natural tendency is not counteracted by business expansion. Against this diminished income, taxation and any other fixed charges must be met at their former monetary value, whilst the claims of the wage-earning class can be reduced but slowly. Hence, the immediate result is a fall in business profits. In these circumstances, in a country such as Great Britain, the "sheltered" industries, that is, those which cater either exclusively or mainly for the home market and do not have to face foreign competition, will attempt to keep up profits by price agreements and restrictive arrangements of various kinds. But the "unsheltered," exporting group, such as the coal or iron and steel industries, can resort to no such measures in the face of world competition, whilst their difficulties may be still further accentuated by the tactics of the sheltered group. Heavy losses weaken such enterprises and cause business failures, whilst the number of the unemployed increases not only in the exporting

group but in those fields of activity related to it, and, ultimately, over the whole field of industry.

Finally, the earning class will benefit from a fall in prices, since their money wages will purchase a larger share of goods and services under the new conditions than they would have under the old. It is between the wage-earning class and the entrepreneur class that the fiercest conflict arises in a time of falling prices. Sacrifices are demanded of both, but the question of which class shall bear them, and in what proportion, is one which creates conflict. The wage-earner will resist a reduction even though the lower rate would leave him with a higher standard of living than he enjoyed before the fall in prices occurred. Actually, wholesale prices fall more quickly than retail prices, so that, although the producer is compelled to accept smaller returns, the consumer fails to receive at once an equal benefit. Professor Bowley has shown that, in England, four-fifths of a movement in wholesale prices is carried forward to affect retail prices two months later. In view of this fact, a reduction in wages would, in the short period at all events, probably reduce the standard of living of the wage-earner. The difficulties of adjusting wage rates to falling prices are accentuated in a country like Great Britain, where labour is strongly organized in trade unions, and where the labour policy of the Government is strongly developed.

> Industry in the nineteenth century braved the passing atmospheric depressions and storms by riding a buoyant boat and throwing, when required, its ballast overboard That ballast was labour. But when labour can no longer be loaded and unloaded at the industrialists' will, the situation is fundamentally changed. States are revolting against this treatment of their citizens, and labour to-day in many countries is ceasing to be a variable and becoming a fixed charge—either directly on the individual concern, or on the community as a whole It is a fixed charge on the community when the unemployed are maintained from the income of the community It is a fixed charge on the individual concern, first in so far as wages do not fluctuate with other values, and secondly in so far as that concern has to bear part of the taxation by which the unemployed are sustained [1]

Ultimately, of course, either production must increase to provide a larger fund out of which these payments may be met, or wages will fall to a level which is in harmony with the new conditions. But this process may be very slow indeed.

[1] Mr. A. Loveday in *Britain and World Trade.*

The influence which falling prices exert on industrial production has already been indicated in the course of the above discussion. Although a fall in prices cannot cause any immediate change in productive equipment, it can undoubtedly cause serious disturbance of productive activity. The losses which arise through causes mentioned above drive some undertakings out of business and cause others to restrict their output. The amount of industrial employment is thereby seriously curtailed, so that the purchasing power of working-class consumers is diminished. This tendency is still further aggravated by falls in wage rates, which occur after a more or less protracted period, varying with the powers of resistance of organized labour. Thus, falling prices which arise from causes other than a natural increase in production, initiate a vicious circle in the sphere of industry, causing diminishing production, which restricts employment and purchasing power, and this in turn curtails production still further.

Again, in agriculture we may discern the same disastrous effects as in manufacturing industry, although the causes are not identical. In the first place, the prices of agricultural products tend to decline more quickly than those of manufactured articles. In effect, therefore, the farmer has to give a greater proportion of his produce in exchange for the manufactured goods which he buys. But, over and above this, on account of minimum wage regulations, his wages bill remains fairly steady though his income decreases. The farmer suffers in a period of falling prices because of the slow rate of turnover which is a characteristic of agricultural operations. He has to wait for a much longer period than a manufacturer from the time when he commences production to the time when he can sell his produce, so that crops prepared and sown at one level of prices may be sold months later at a lower level, involving a heavy loss on the whole process, which the farmer can take no measures to avert.

In a period of rising prices the economic effects are, broadly speaking, the reverse of those discussed in connection with falling prices. The investing class, with fixed incomes, now find that they can purchase fewer goods and services than before, so that they lose ground relatively to other classes. The immediate gains now tend to be obtained by the entrepreneur class, for the business enterprise obtains a larger income because of the higher prices which are

prevailing, whilst it does not have to pay correspondingly higher costs. Wages and salaries, for example, may be fixed by agreements which are not immediately revised, whilst rent and interest charges remain constant. At first, therefore, the wage-earning classes also lose ground, since prices rise but wages do not rise in sympathy. This state does not persist for long, and pressure is gradually brought to bear upon the employing class for increases in wage rates. These increases will be resisted, but, in all probability, will not provoke the same measure of conflict as would arise over wage adjustments in a period of falling prices. The effect of rising prices is to stimulate business enterprise and increase the demand for capital goods Yet the entrepreneur class does not invariably reap the benefits of rising prices. Those firms which have entered into long-term contracts for the supply of goods find their material and labour costs rising whilst their selling prices have to remain fixed—unless they have provided for some adjustment in the terms of the contract. In a period of rising prices, then, we still find an arbitrary redistribution of the national income taking place, now debtors gaining at the expense of creditors.

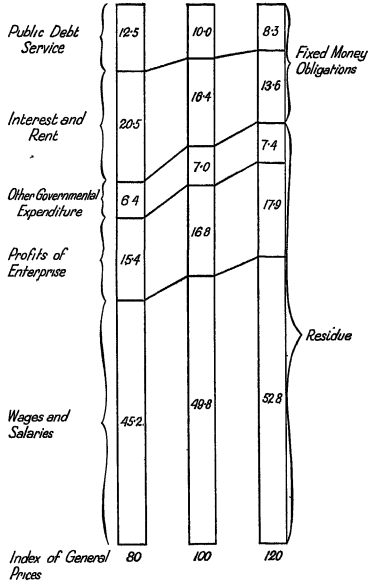
The following table[1] shows approximately the change in the distribution of the national income at different levels of prices.

TABLE SHOWING THE DISTRIBUTION OF THE NATIONAL INCOME AT DIFFERENT LEVELS OF PRICES

Price level =	80	100	120
	£ Millions	£ Millions	£ Millions
(a) Public debt service	405	405	405
(b) Interest and rent	665	665	665
Fixed money obligations	1,070	1,070	1,070
(1) Other governmental expenditure	208	285	362
(2) Profits of enterprise	499	685	871
(3) Wages and salaries	1,471	2,020	2,569
Residue	£2,178	£2,990	£3,802
Total	£3,248	£4,060	£4,872

[1] Taken from a Memorandum on "Monetary Stability and the Gold Standard," submitted by Sir Henry Strakosch to the Gold Delegation of the League of Nations

DIAGRAM ILLUSTRATING CHANGES IN THE DISTRIBUTION OF NATIONAL PRODUCTION AS A RESULT OF CHANGES IN THE GENERAL LEVEL OF PRICES, THE VOLUME OF PRODUCTION BEING CONSTANT



The distribution of the national income has been split up into the constituents of (*a*) Public Debt Service and (*b*) Interest and Rent, which are grouped together under the main heading of "Fixed Money Obligations"; and (1) Other Governmental Expenditure, (2) Profits of Enterprise, and (3) Wages and Salaries, grouped collectively under the main heading of "Residue." The first group comprises the obligations in respect of contracts involving fixed money payments. It includes, apart from interest and redemption charges on the National Debt, the interest on debts of public bodies and private undertakings, also rent on landed and house property and pensions. These obligations may be said to constitute a first charge on the national income. They have to be met whatever the income may be, if the default is to be avoided. The second group headed "Residue," represents the balance of the national income that is available to meet (*a*) Governmental Expenditure other than debt charges, (*b*) Profits of Enterprise, which includes all dividends of a variable type, such as accrue to holders of ordinary or deferred shares of companies, and, finally, (*c*) Wages and Salaries. It is this "Residue" that, on the one hand, has to bear the burden of any deficiency of production or any fall in the price level, and that, on the other hand, reaps the benefit of an increase of production, or a rise in the general level of prices. The same figures are illustrated as percentages in the diagram on page 25.

TEST PAPER 1

1. What is meant by the "value of money"? What difficulties arise in applying the general theory of value to money?
2. Explain generally the method on which index numbers are constructed, and the precautions which are necessary in order to avoid misleading results.
3. Construct an "index" number for any five commodities you like, comparing their prices, as far as you can ascertain, ten years ago and now, and show what change, if any, in the purchasing power of money is thus suggested
4. "The value of money both within one country and between countries is determined by the demand for it in relation to the supply available" Consider this statement
5. Indicate how the laws of supply and demand operate in determining the value of money. Define exactly the sense in which you intend "money" to be understood, and justify your use of the term.

6. What is meant by the Quantity Theory of Money? State any objections that have been brought against the theory and say how far, in your opinion, these objections can be justified.
7. What is the effect of rapidity of circulation of money on prices?
8. If the money in everybody's purse were miraculously doubled, what would be the effect on prices?
9. Criticize the proposition that "general prices are directly proportionate to the quantity of money in circulation." How would you amend this statement of the theory of the value of money?
10. Explain the terms "inflation" and "deflation." How would you measure the degree of inflation of a country's currency?
11. What effect would you expect a long-continued rise in the price level to have upon the accumulation of capital?
12. What are the chief effects upon the distribution of the national income of a gradual rise in the general level of prices?
13. Examine the consequences to the various groups in the community of alterations in the purchasing power of money, and suggest any means which you think might prevent such alterations
14. How does a general rise in prices affect—
    (1) The business section of the community?
    (2) The wage-earners?
    (3) Salaried earners?
    (4) The investing class?

    Illustrate from post-war conditions in Europe
15. Examine the nature of the proposals for a "managed currency" for the purpose of maintaining a stabilized level of prices, and point out the difficulties involved
16. Which would you choose—a slowly falling, a slowly rising, or a steady price level? Would you advocate State action to help in achieving your choice?
17. "In order to secure stability in the price level, some central authority would have to enter into a written contract with Nature" Discuss this statement in relation to proposals for stabilizing the price level
18. In spite of the fact that we have paid off several hundred millions of pounds in the interval, the real burden of the National Debt is greater now than at the end of the War. What is meant by this statement?

CHAPTER II

MONETARY STANDARDS

WE have, in the course of the last chapter, examined certain of the general relationships existing between money and the general level of prices, and we have considered some of the very serious consequences which may arise through instability in the value of money. There is some considerable difference of opinion as to the precise significance which must be attached to monetary and non-monetary factors in setting up long-period fluctuations in the general level of prices. Yet, as the Macmillan Committee pointed out in their report—

> The general price level must be governed by the volume of purchasing power directed to the buying of current output relative to the volume of this output Moreover, the behaviour of the world's banking and monetary systems as a whole must have a considerable influence on the volume of such purchasing power. To this extent, at least, the general price level is rightly described as a monetary phenomenon; and the controversy turns on the degree to which in practice a monetary system can exert its influence to remove difficulties due to changes in the rate at which such purchasing power circulates or in the uses to which it is put.[1]

It is an impossibility to separate monetary from non-monetary factors and to consider them apart, since each exerts a powerful influence upon the other. So far as the monetary aspect of the question is concerned, discussion has centred upon the nature of the standard which should be employed in order that the functions of money may best be fulfilled.[2] In this connection there is one school of thought which would remain true to tradition and adopt some form of gold standard, whilst others propose some different manner of regulation.

OBJECTS OF THE GOLD STANDARD. In modern times, the monetary standard upon which the leading commercial nations of the world have pinned their faith is that of gold. For centuries, gold has

[1] *Report of the Committee on Finance and Industry.* Cmd. 3897.
[2] For a discussion of the Nature and Functions of Money, see *Economics of Production and Exchange* (Pitman), by the same authors.

stood, rightly or wrongly, as the symbol of solid, substantial wealth, and has been a serviceable standard of value. At all times, and amongst people at every stage of economic development, gold has been held in high esteem, partly on account of its scarcity and partly on account of its attractive appearance and utility. Yet, it is only within comparatively recent times that the "gold standard" has gained anything like wide acceptance. England, the pioneer of its introduction, did not establish it by any conscious and deliberate act. Edward III attempted to introduce a gold florin, but his scheme was a failure. During the seventeenth century both gold and silver were coined, but owing to the fact that the trade with the East as conducted by the East India Company required large quantities of silver, the relative value of silver as compared with gold tended to increase. Following a report presented by Sir Isaac Newton the Government reduced the price of the guinea from 21s. 6d. to 21s., but even at this figure it was over-valued. For the next thirty years there were heavy issues of gold coin and a continuous disappearance of silver until, by the middle of the eighteenth century gold had definitely supplanted silver. It was not, however, until the last thirty years of the nineteenth century that the other European powers followed the example of England, though by the close of the century there was no important European state whose currency was not either based on gold or related to it.

When we refer to a country as being on a gold standard we do not thereby infer that there is a uniformity in the currency arrangements of all the countries comprising the gold standard group. *A gold standard exists when the monetary unit of a country—for example, the pound, the dollar, or the franc—is defined in terms of a fixed weight of gold and where, by law or custom, any other means of payment can be freely converted into gold or the equivalent of gold.* It is not absolutely necessary that this right of convertibility shall be conferred by statute; it is sufficient if the currency authority never refuses to give gold or the equivalent at a fixed price for the local currency, or *vice versa*. Secondly, in addition to this right of convertibility, there must exist an unrestricted right to import and export gold. Hence, when we speak of an international gold standard, we refer to—

> . . the simultaneous presence, in a group of countries, of arrangements by which, in each of them, gold is convertible at a fixed rate into the

local currency and the local currency into gold, and by which gold movements from any one of these areas to any of the others are freely permitted by all of them [1]

The first and most important objective of the international gold standard is to keep the exchange rates of the different national currencies as constant as possible, and this has the effect of securing a certain measure of correspondence in the levels of prices ruling all over the gold standard area. The number of monetary systems in the world is legion; most countries possess their own national unit of account by which they measure the value of their goods and services. When, therefore, trade takes place between one nation and another, each of which has a different monetary unit, we require some reliable method of ascertaining the exchange value of the goods. It is evident that the task will be made much more simple if each monetary unit is capable of being expressed in terms of a common commodity—gold. Under such an arrangement we are certain that a pound is, within narrow limits, worth a fixed number of francs or dollars as the case may be. Formerly, in many cases, the transfer of goods took place against gold itself, but the growth in the volume of international trading transactions has made the use of credit instruments imperative. Nowadays, therefore, the process is indirect and the exchange rates of the different currencies are kept constant by making the actual instruments of payment employed convertible at a fixed rate into a single commodity which, in most cases, is gold. This option of convertibility is exercised only in a minority of cases, but its existence is sufficient to secure the requisite degree of stability.

Further, the gold standard furnishes an objective test of the correspondence of the local currency policy with that pursued by the rest of the world, and at the same time provides the means whereby any temporary disequilibrium may be put right. Such a temporary disequilibrium may arise from a sudden check to exports due to the failure of a crop in an exporting country. What is required in such a case is the possession of some one exportable commodity, the value of which will not fall—in the short period at all events. Gold is such a commodity which can be employed in moments of emergency. The

[1] Dr. T E. Gregory, *The Gold Standard and its Future.*

manner of its working may be illustrated by the following example. Let us suppose that in two countries gold coin is the only medium of exchange available and that in one of them, which is purely agricultural, there is a failure of the harvest which causes a sudden drop in exports. Imports of manufactured goods from the other country are not appreciably diminished, so that there is an excess of imports over exports, the surplus being paid for by an export of gold. This loss of gold will have diminished the total amount of money available in the agricultural country, so that each unit will purchase more goods in the home market or, in other words, the general level of prices will fall. This decrease in domestic prices will have made foreign goods less attractive as compared with home-produced goods so that imports will receive a check. On the other hand, the low level of prices will create a favourable market for foreigners to buy in, so that imports will tend to be stimulated. This tendency will be accentuated by the fact that the country receiving the gold will have experienced a rise in prices This movement will go on until imports and exports between the two countries balance one another at the new level of prices.

In actual fact, of course, the position here outlined has an artificial simplicity which is somewhat removed from actual experience. In no country is payment effected by the use of gold alone, whilst under post-war conditions, it is rarely employed at all The internal currency of most countries is now supplied by legal tender bank notes, a subsidiary or token coinage, cheques, and other credit instruments. In a gold standard country, a certain proportion of this credit currency stands in some relationship to the quantity of gold available, but the precise effect of an influx or an efflux of gold upon the price structure is apt to be very indeterminate For example, if the gold goes into the hands of the central bank which can issue, say, notes up to three times the amount of its gold reserve, then the acquisition of gold may have an effect on the price structure which is disproportionate to its magnitude. On the other hand, if the central bank uses the additional gold merely to strengthen its reserves, it will have no effect whatsoever on the general level of prices. Under conditions where the system is allowed to function properly, however, the general result is to achieve an equilibrium between the price and income structures of the various countries. The international gold

standard does not, however, imply an identical price level in all areas covered by it—

What the international gold standard does do is to force prices and money incomes in different trading areas into such a relationship that the balance of payments can be adjusted without gold flows in either direction. To put the matter somewhat differently, the international gold standard creates, *not a common price level but an integrated price-and-income structure*, the various parts of which stand in an organic relationship to one another.[1]

Another objective of an international gold standard is to attempt to preserve a reasonable stability of international prices, not only over space, but also over time. The mere existence of such a standard does not, however, guarantee stability of prices either over space or over time. As Mr. J. M. Keynes has pointed out, such stability as the gold standard has achieved in the past, cannot be attributed to any inherent tendency on the part of supplies of the metal to keep step with the demand for it.

I think it is an illusion to suppose that there are any special characteristics governing the supply of gold which make it likely to furnish automatically a stable standard of value, except the characteristic which it shares with all durable goods—namely, that the increment of the total supply in any year is likely to be very small. Apart from this, gold has depended, and will continue to depend, for its stability of value, not so much on the conditions of its supply, as on deliberate regulation of the demand [2]

Although gold, in common with other instrumental goods, is relatively stable in value, it has been found in the past to offer us no really effective guarantee of immunity from fluctuations in the general level of prices over a long term of years. Numerous historical examples are to be found to demonstrate the instability of gold prices. As a result of Alexander's campaign in Persia, for instance, such enormous sums of gold were brought back that the level of prices in the Levantine world was completely disorganized. In modern times, between 1874 and 1896 the value of gold increased by about 40 per cent because of a decline in output in the face of increasing demand, and consequently caused a disastrous fall in prices. In 1886 the rich gold deposits of the Rand were opened up whilst, almost at the same time, the cyanide process was introduced, thereby providing a more efficient method of extracting the metal

[1] Dr. T. E. Gregory, *op cit*

[2] J. M. Keynes, *A Treatise on Money, Vol. II*

from the ore. As a result, the level of gold prices rose steadily from 1896 onwards.

Again, in the post-war period, between 1925 and 1930, gold appreciated in value by about 28 per cent, so that in actual practice the adoption of a gold standard is far from ensuring stability of prices over periods of time. As Sir Henry Strakosch has put it, the nations of the world have been content to tie their currency and price level ships to a common buoy—gold, but they have no guarantee that the buoy is itself firmly anchored. There is nothing in the construction of the gold buoy to prevent it from yielding to the currents of supply and demand, and from drifting to wherever these may take it, dragging with it the ships that are made fast to it.

CHANGES IN THE GOLD STANDARD. The gold standard to which we have become accustomed in the post-war period differs in a number of material ways from that which prevailed in pre-war days. Possibly the most significant and far-reaching of these changes has been the dethronement of gold as a circulating medium of exchange.

> The long age of commodity money has at last passed finally away before the age of representative money. Gold has ceased to be a coin, a hoard, a tangible claim to wealth, of which the value cannot slip away so long as the hand of the individual clutches the material stuff It has become a much more abstract thing—just a standard of value; and it only keeps this nominal status by being handed round from time to time in quite small quantities amongst a group of central banks, on the occasions when one of them has been inflating or deflating its managed representative money in a different degree from what is appropriate to the behaviour of its neighbours.[1]

Prior to the outbreak of the World War, the monetary system of most gold standard countries was composed of gold coin, bank notes, cheques drawn on sight deposits, and a subsidiary coinage. Gold was in free circulation, and drifted in and out of the bank reserves. In 1914, however, there was a widespread suspension of gold payments and the minting of gold coin was stopped. The active gold circulation shrank rapidly and was replaced by notes, whilst the bulk of the gold stocks of the belligerent countries became concentrated in the vaults of the central banks. In England, for example, although the new currency notes were nominally convertible into gold, the public were appealed to by every possible means, through the Press, in Parliament, and by the banks, not to ask for

[1] J M. Keynes, *op cit.*

gold. Although there was no definite legal abandonment of the gold standard in this country during the War, the Government, by administrative action, gradually weakened the link with gold.

Since the War attempts have been made to bring about a revival of the circulation of gold coin, chiefly in Holland and Switzerland, but these have been unsuccessful, as the public have largely lost the habit of using gold. In 1925, England created a new system under which the obligatory conversion of notes into gold coin was abandoned and notes were convertible merely into gold bars. Under the Gold Standard Act of that year, the Bank of England was compelled to sell gold in bars of approximately 400 ounces of fine gold at the rate of £3 17s. 10½d. per ounce of standard gold to any person who asked for it. It is interesting to note that Ricardo had advocated a very similar plan in 1819 when the resumption of cash payments by the Bank was under discussion. He suggested that bank notes should be made convertible into bullion only, that gold coin should not be put into circulation, and that small notes should be made legal tender instead. It was this system which came into operation in 1925 under the name of the *gold bullion standard*, in contrast to that prevailing in pre-war days known as the *gold specie* or *full gold standard*. In 1928, the French introduced a variation of this new system when the Bank of France was given the option of redeeming notes either in gold bars or in gold coin In support of the gold bullion standard and against the free circulation of gold coin, it has been said—

> The economic reasons against putting gold into circulation are simple and clear. If the gold in the reserve is transferred to the circulation, the structure of credit that can be built on that reserve is *pro tanto* reduced. The greater the proportion of gold in circulation, the less the elasticity of the currency system. In a system that consists solely of gold coins, there can be no elasticity as the currency can only be increased by taking payment in gold for the balance of exports over imports and it can be decreased by the contrary process only. In short, the less the gold in circulation the more will be the gold in the reserves and the greater the elasticity of the structure of credit that can be built thereon.[1]

In pre-war days, under a gold specie standard, the gold reserves of any country consisted in the coin in circulation, together with the reserves held in the central bank. At the present day, however, with

[1] *Report of the Royal Commission on Indian Currency and Finance* (Cmd. 2687).

a gold bullion standard, the reserve in the hands of the central bank represents, to all intents and purposes, the total gold reserve of a country. The consequence of this concentration has been to effect some economy in the use of gold. Indeed, the system was adopted largely as the outcome of apprehensions of a shortage of gold which were expressed at the Brussels and Genoa Conferences. The concentration of gold in the hands of a central bank does not increase the gold holdings of a country, but it ensures its more effective employment in the creation of credit, and the role which it plays in the market gains in relative importance.

Since the War, however, not only have gold reserves tended to become concentrated in the hands of central banks, but in many cases such reserves have been either supplemented or replaced by other types of security. The nature of the reserves which are permitted by the charters of such central banks are subject to considerable variation, and consist, not only of metal, but also of foreign exchange claims in external currencies, or short-term securities convertible into gold—often referred to as *divisen*. This arrangement is known as the *gold exchange standard* which, although practised in pre-war days, was not worked in the same way as at present. Before the War, though central banks might have power to hold foreign exchange as part of their reserves, they could redeem their notes in gold coin only. Since the War, bank charters have been modified so that notes may be converted into gold either in the form of coin or bullion, or into foreign exchange which is itself legally convertible into gold.

The popularity of the gold exchange standard is based upon the assumption that foreign exchange is as good as gold as cover for the national currency. In point of fact it is not so regarded by many people. There would appear to be a certain stigma attached to a gold exchange standard on account of an implication that it is adopted only by those countries which are economically weak. Again, a gold exchange standard may not command any great measure of confidence amongst a people in a primitive stage of economic development. Thus, in examining the case for such a system in India, it was said that—

> The basic right of convertibility that supports an exchange standard is too abstract for the present conditions in India—the backing which it

supplies for the token currency is too intangible and invisible. Without some backing more certain, simple, and solid, confidence in the stability of the currency will grow more slowly than it should, if it grows at all, and progress in the habits of banking and investment will be delayed.[1]

Partly on account of the disfavour with which this system has been regarded, many central banks have adopted it as a kind of transitional measure until such time as they are in a position to return to a gold bullion standard. In their view, holdings of interest-bearing foreign securities are not nearly so attractive as a stock of unproductive gold in the central bank.

Again, the gold exchange system considerably complicates the working of the gold standard on an international basis. In the first place, it leads to an inflation of the international credit structure inasmuch as the same gold functions twice over—once in the country where it is actually held, and again in the gold exchange country where the securities which give a title to the gold are used as cover for the note issue. More important still, however, is the fact that the movement of foreign exchange from one country to another has by no means the same reaction on their price structures as a movement of gold. Under the pre-war gold specie standard, when gold left one country the credit structure shrank, whilst that of the receiving country expanded to a like extent. In the case of the gold exchange standard, when a central bank purchases foreign exchange, it increases the amount of its note issue, but at the same time there is no shrinkage in the credit structure of the country from which the foreign exchange is obtained Or, to take another example—

If a central bank keeps its foreign assets in the form of a sight deposit in a foreign commercial bank in a gold centre and sells its claims on that bank to a trader who has obligations to meet in that market, conditions will be created tending to compel it to curtail credit at home. But no reciprocal conditions will be created in the country in which the commercial bank is situated. The commercial bank may find that the only change in its position is a substitution of a domestic for a foreign depositor. Moreover, the central bank in this country may have remained unaware of the transaction and be deprived therefore of the means of obtaining immediately information which might prove important for the conduct of its policy.[2]

[1] *Report of the Royal Commission on Indian Currency and Finance* (Cmd 2687).
[2] League of Nations, *Second Interim Report of the Gold Delegation of the Financial Committee.*

The foregoing changes in the functioning of the gold standard have largely been dictated by the desire to effect economies in the use of gold. There have, unfortunately, been other tendencies operating in the reverse direction, the chief of which has been a tendency to increase the minimum reserve requirements of central banks. The magnitude of this minimum reserve varies as between one country and another in accordance with the nature of their economic organization. In actual fact, the minimum reserves which are required by law are, in most cases, the outcome of tradition. The minimum legal requirement appears usually to be in the neighbourhood of 33 per cent. This percentage seems to have been adopted from the nineteenth century practice of the Bank of England which, after the passing of the Bank Charter Act in 1844, used to maintain a cash proportion of about 40 per cent.

In pre-war days, the reserve was usually calculated at about one-third of the note circulation, but now it is frequently based on the total amount of sight liabilities as well. Further, in so far as the central banks cannot allow their reserves to fall below the minimum without infringing the law, they must accumulate a surplus over and above this figure in order that they may have the means wherewith to fulfil the ordinary working of the gold standard. Thus, all the central banks, whatever their legal requirements of cover may be, keep a margin above that legal minimum, and sometimes a considerable margin. Working on a basis of a minimum reserve of 33 per cent, a bank of issue will naturally desire to have 40 to 50 per cent in gold in order to meet contingencies. Again, although the gold exchange standard is usually considered as one which effects economies in the use of gold, in practice many central banks operating such a standard show a marked preference for gold in their reserves.

RECENT FUNCTIONING OF THE GOLD STANDARD. Partly on account of the changes in the nature of the gold standard, and partly on account of the different economic environment, which in itself has done much to occasion the change, the post-war gold standard has worked in a manner quite different from that of pre-war days and, in many respects, in a manner much less satisfactory. In consequence, ever since 1925, when the work of restoring the standard in Europe began, until 1931, when it was once more abandoned over a wide area, it has been exposed to continual criticism.

In the first place, certain of the difficulties of working the post-war gold standard appear to have been caused by the terms upon which different countries reverted to it. Great Britain was the first country to declare her monetary policy after the War when, in 1925, she decided to return to the gold standard at a pre-war parity. Her large foreign investments and her widespread banking and financial interests provided a special incentive to this course of action while, in addition, it was felt that she was under a certain obligation to give a lead to other nations to restore order to their chaotic currency systems. Unfortunately, her example was not followed, with the result that—

> Great Britain established a gold parity which meant that her existing level of sterling incomes and costs was relatively too high in terms of gold, so that, failing a downward adjustment, those of her industries which are subject to foreign competition were put at an artificial disadvantage. France and Belgium, on the other hand, somewhat later established a gold parity which, pending an upward adjustment of their wages and other costs in terms of francs, gave an artificial advantage to their export industries.[1]

The reversion of this country to the gold standard on these terms was not achieved without protest. The Federation of British Industries, for instance, in a memorandum submitted to the Cunliffe Committee, pointed out that the immediate result of a return to the gold standard would be the raising of the exchange value of sterling to parity with the American dollar. Since the position of the exchanges between two countries ultimately depends on the level of prices within them, and British prices were then said to be 10 per cent above American prices, a return to parity with the dollar involved either a *fall* in British prices through drastic deflation or a *rise* in American prices through a corresponding inflation there. The accuracy of this figure of 10 per cent for the difference in price levels has been called to question by Professor Gregory, since a comparison founded on different index numbers shows that the pound was undervalued in terms of dollars in 1924. Hence, "the immediate results of the return to the gold standard were consistent with *either* view—with the view that this step led to an overvalued exchange or with the view that the parity actually chosen ended a period of undervaluation."[2]

[1] *Report of the Committee on Finance and Industry.*
[2] Dr. T. E. Gregory, *op. cit.*

Country	Nature of Standard	Statutory Requirements Governing Redemption of Notes	Provisions Governing Statutory Reserves of Central Bank
Great Britain	Gold Bullion Standard.	The Bank of England is under obligation to buy gold in exchange for notes at £3 17s. 9d. per ounce standard, and to sell gold bullion at £3 17s. 10½d. per ounce standard subject to a minimum of approximately 400 ounces troy of fine gold.	Fiduciary issue fixed at £260 millions. Balance of notes to be covered by gold held in Issue Department. Powers are reserved to the Treasury and Bank, acting together, to decrease or increase the amount of the fiduciary issue.
France . .	Gold Bullion and Specie Standard.	The Bank of France is required to redeem its notes in gold on demand. The Bank has the choice between French gold coins and gold bullion. By agreement between the Minister of Finance and the Bank, a minimum can be fixed for the amounts to be redeemed. The Bank is required to purchase gold on demand at a fixed price less minting and assaying costs.	Notes are issued against cash discounts or loans, the Bank being obliged to maintain a minimum reserve in gold bullion or gold coin of at least 35 per cent of the total sum of the note circulation plus current credit accounts.
U.S.A.	Gold Specie Standard.	Federal Reserve notes are redeemable in gold coin at the Treasury or in gold coin or lawful money at the Federal Reserve Bank.	Federal Reserve Banks to hold (*a*) not less than 35 per cent in gold or lawful money against deposits; (*b*) not less than 40 per cent in gold against notes in circulation. Balance of note issue to be covered by drafts or bills of exchange of specified character.
Belgium	Gold Exchange Standard.	The National Bank of Belgium is required on demand to redeem its notes in one of the following forms, the option resting with the Bank: (*a*) gold; (*b*) silver at its value in gold; (*c*) foreign gold exchange. The National Bank is not required to purchase gold offered to it.	The National Bank is required to hold a reserve in gold and foreign exchange convertible into gold of at least 40 per cent of its total sight deposits At least 30 per cent of the total sight liabilities must be covered by gold.
Australia .	Gold Specie Standard.	Australian notes are Government obligations and bear the promise of the Treasurer of the Commonwealth to redeem them in gold coin on demand at the head office of the Commonwealth Bank The Bank is not required to purchase gold offered to it.	The Bank is required to hold in gold coin and bullion a reserve of an amount not less than one-fourth of the amount of Australian notes issued.
Greece	Gold Exchange Standard.	The Bank of Greece must sell or purchase for immediate delivery, in exchange for local legal tender currency, the legal tender currency of such gold standard countries as may be notified officially.	The Bank to maintain a reserve of not less than 40 per cent of the value of notes in circulation and other demand liabilities. The reserve must include only (*a*) gold coin or bullion and (*b*) net foreign gold exchange (i.e. balances at credit of Bank with foreign central banks *less* any liabilities in foreign exchange).

Based on material collected by the League of Nations Gold Delegation, published in "Legislation on Gold," and on a memorandum by C. H. Kisch, printed in "The International Gold Problem." The above legal provisions still hold good, even though in some cases they have been suspended in 1931.

Great Britain therefore returned to the gold standard at the pre-war parity as a result of a determination on the part of the City of London to maintain its position as the world's financial centre. It was felt that the international gold standard had, in pre-war days, conferred immense benefits on all the trading nations by providing an international means of payment and furthering development and production all over the world. It was hoped that by its restoration these benefits would once again be enjoyed by those adhering to it. As a great creditor country, the deflation which this policy entailed conferred certain advantages inasmuch as it compelled our debtors, who mostly owed us debts reckoned in our own currency, to pay us more in real things as the value of the pound went up. Yet, there have been many forebodings as to the consequences of this policy not only from interests in this country, but also from observers abroad. Thus, M. André Siegfried, writing in his much-discussed book, *England's Crisis*, before the abandonment of the gold standard in September, 1931, said—

> England has achieved a state of financial equilibrium but not an economic balance The last word, however, has not yet been said, for if the pound is kept at the present level and the financial prestige of the nation is maintained, it may cost England her financial power, since that power is based on, and is inseparable from, a prosperous industry An ingrained instinct caused the Government, rightly or wrongly, to consider restoring the currency as an essential duty, but in the last analysis it is industry which has to pay for saving the pound sterling.

Now it is quite true that the stabilization of the pound at its pre-war parity, involving as it did a rise in its value, was bound to throw a strain on industry, particularly the exporting trades, and that this strain might become unendurable if they failed to meet the position by a downward revision of costs. None the less, it is difficult to attribute to monetary policy all the misfortunes which have afflicted British industry since 1925, as some observers have maintained. In fact, the functioning of the gold standard and the fortunes of British industry have alike been affected since the War by a variety of new economic influences.

One complication which has arisen since the War is the fact that the power to lend capital has been disturbed. In pre-war days, England, France, and to a smaller extent Germany and other Continental countries, lent year by year some £300,000,000 of new

capital to developing countries, amongst which America was by far the most important. After the War, however, the whole position had changed, for Germany had become a borrower, whilst France, in consequence of the losses which she had suffered in Russia, was reluctant to act in the role of a long-term lender, although she possessed the necessary resources, but preferred to invest capital in short-term loans. In the case of Great Britain, there was available only a much smaller surplus of funds for new investment, and of the amount which was available, a greater proportion was being invested at home. Finally, during the War America changed completely from a debtor to a large creditor country and, in consequence of the large sums due to her annually in respect of payments of interest, had a considerable surplus available for investment. As the authors of the Macmillan Report pointed out, however—

> This re-distribution of lending power need not, however, in itself have interfered with the working of the gold standard. The difficulties have arisen through the partial failure of the two recipients, during the last two or three years, to employ the receipts in the way in which Great Britain had always employed hers, namely, either in the purchase of additional imports or in making additional foreign loans on long-term. On the contrary, they have required payment of a large part of their annual surplus either in actual gold or in short-term liquid claims. This is a contingency which the normal working of the international gold standard does not contemplate and for which it does not provide

One important contributory cause of this unsatisfactory state of international investment may be ascribed to the very high degree of political influence which has been exercised in economic affairs since the end of the War. We have seen the creation of an intense nationalistic spirit in Europe, a totally new regime in Russia, the complete consequences of which cannot yet be foreseen, extreme discontent in India, and an ever-increasing condition of strain in the Far East. These, and many other events, have shaken the confidence which is so vitally necessary for international investment. Most unsatisfactory of all, however, have been the problems arising out of the settlement of war debts and reparations. During the War each belligerent country borrowed large sums of money in order to meet its heavy burden of expenditure. The greater part of these sums was from the subjects of the country concerned, but very large amounts were also borrowed abroad, especially from the United States which, both before and after their entry into the War, supplied

Europe with large quantities of goods without receiving any equivalent imports from Europe. In consequence, after the War was ended, the European countries owed large sums for interest and repayment of principal to the United States, and in addition, most of them also owed considerable amounts to Great Britain. These debtor countries, in order to obtain some degree of relief from the crushing weight of these burdens, have attempted to collect from Germany the means of paying their debts. The position of this country in respect of these matters was defined in 1922, when under the terms of the Balfour Note she declared that she would receive from her foreign debtors neither more nor less than she had to pay on her own war debt to America. But countries such as France and Belgium, which had suffered from a wholesale destruction of property during the period of hostilities, were by no means inclined to adopt a similar attitude. These countries felt themselves entitled to claim from the Germans a great deal more than they owed to America, in order to assist in the restoration of their devastated areas and to lessen their own internal burden of taxation.

The financial complications which have arisen in consequence of attempts to arrive at a settlement have undoubtedly played a very important part in the creation of the acute crisis of 1931. The new creditor countries—particularly the United States in regard to war debts and France in respect of reparations payments—have not shown themselves alive to the responsibilities of their position. Broadly speaking, a debtor country can pay interest and capital in terms of goods, or of services, or in gold, or in securities—the most usual method being the first. Thus, in the past, Great Britain has filled the role of creditor country with conspicuous success because she has shown herself willing to accept payment in goods, whilst British investors have shown great willingness to invest capital abroad. In the case of the United States, payment in goods has proved to be an impossibility because she maintained a high protective tariff in order to exclude those goods in which alone Europe had the means to pay For a time the situation was met by the reinvestment of these sums due to America in long-term loans to Europe, but in 1928 this investment ceased. In consequence, the European debtor nations have had to settle their indebtedness by the transmission of gold. In common with the United States,

although for rather different reasons, France also enjoys a strong creditor position with the same result, namely, that gold has shown a persistent tendency to flow to Paris and remain there. In order to meet this combined demand, the debtor countries poured out their gold until their supplies were on the verge of exhaustion, so that France and the United States soon found themselves in possession of the major portion of the world's gold stocks. Now, as Sir Henry Strakosch has pointed out—

> If the gold standard had been allowed to function as it is meant to function, the influx of gold would have increased the available purchasing power of the community in the gold-receiving countries, and would have raised their domestic level of prices. They would thus have become, for other countries, favourable markets to sell in and unfavourable markets to buy from. Imports into the gold receiving countries would have been fostered and exports impeded If these movements had been allowed free play, the effect would have been to establish a new equilibrium between imports and exports, and thus to stop or circumscribe the flow of gold But the two countries disliked seeing such a new equilibrium established because they doubtless feared that it would produce inconvenient reactions on their domestic industries. The inflow of gold was therefore prevented from exercising its influence on their price levels, and tariffs and other barriers were placed in the path of imports.[1]

SUPPLY AND DISTRIBUTION OF GOLD. There has recently been made a number of attempts to explain the deficiencies of the gold standard. Some writers have attributed the difficulties of working to an absolute scarcity of gold, whereas others, reasoning on the lines indicated above, blame the faulty management of the standard by certain nations, leading to a mal-distribution of gold amongst the countries employing it. Those who talk of a world scarcity of gold argue that the total stock of the metal is being increased at a slower rate than that at which the production of goods is increasing, and, consequently, money incomes cannot be increased through the structure of notes and credit as rapidly as goods are produced. The central banking institutions of the world, therefore, engage in a scramble for such supplies of gold as are available, money becomes more valuable, prices fall, and depression sets in. In considering the question of gold scarcity, we have first to determine what constitutes a "sufficient supply" of gold. This may be said to depend largely upon two factors which are themselves of a complex nature. It

[1] *The Crisis*, a memorandum printed as a supplement to *The Economist*.

depends firstly upon the rate of growth of production and population in the gold-using countries, and secondly, upon the existing practices of central banking institutions. If, in the face of these variable factors, the supply of gold is such as to enable a constant level of prices to be maintained, then we may say that it is adequate

It has been maintained by certain writers, such as Professor Cassel, that the stock of monetary gold is being added to at a slower rate than that at which the physical output of the world's industry and trade is increasing, and that this deficiency of gold has played a decisive role in the world slump in prices of 1929-32. Yet the validity of this conclusion is difficult to accept, since all the known facts of the case do not lend support to it.

> The issue can only be settled by an appeal to the known fact that between 1925 and 1929 the world was passing through an epoch of great economic progress. The gold supplies and the volume of purchasing power built upon these supplies must have been sufficient to support that advance, for it in fact took place No change in the supply of gold has since taken place sufficient to explain the altered circumstances.[1]

The annual increase in gold supplies was rather less than 4 per cent of the existing stock, and it is hardly likely that a fall in this increase would affect prices suddenly and seriously. Moreover, there is considerable elasticity in the structure of credit which is built on gold, so that it is possible for money incomes to vary to some extent apart from gold reserves.

With regard to the future, the position is more uncertain It has been calculated that an increase of about 3 per cent per annum in monetary gold stocks is required in order to keep prices stable if the world's rate of development is not slowed down. Yet it is anticipated that after 1932 there is likely to be a substantial decline in gold production—a decline which is likely to gather momentum after 1935 on account of the gradual exhaustion of the South African mines. The need for this 3 per cent increase, which has been stressed both by Mr. Kitchen and Professor Cassel, has been criticized on a number of grounds. The figure was based on the actual experience of the years 1850 to 1910. During this period, however, practically the whole western world changed over from a silver to a gold standard, so that any demand for gold was something that had

[1] Dr. T. E. Gregory, *op. cit.*

no relation whatever to normal monetary growth. Further, the same period saw a great development of credit instruments and organization tending to effect great economies in gold. It would in consequence appear that any comparison of the facts of this period with those of our own day may easily lead to totally unwarranted conclusions.

Whilst the available figures serve as a warning that, unless definite steps are taken to avoid the danger, a fall of prices due to insufficiency of gold will undoubtedly occur in the future, they by no means prove that the gold problem is one so closely linked with the physical facts of gold production as to make the outlook in any way a hopeless one. On the contrary, it seems probable that, given good will and understanding on the part of the world's monetary authorities, the dangers threatening the price level can be postponed for a period of time sufficiently long to deprive the problem of practical importance.[1]

ECONOMY IN GOLD. Certain lines of policy have been indicated by the League of Nations Gold Delegation in order to avoid a future shortage in the supply of gold, such as—

1. Concentration of Gold in the Reserves of Central Banks. As already pointed out in discussing the post-war gold standard, there has been a widespread discontinuance of the use of gold coin for domestic currency purposes. This practice does not, of course, increase the gold stocks of a country, though it does ensure that they will find more effective employment for monetary purposes. It has facilitated the administrative work of those responsible for monetary policy by enabling banks of issue to follow from week to week the variations which take place in the total demand for currency. It has also discouraged hoarding, which constitutes a direct and useless charge on the gold supplies of a community. The issue of gold certificates—a form of currency employed in the United States—is almost as wasteful as gold coin in circulation. Gold certificates are, in fact, merely a kind of warehouse receipt giving the public the option of holding either the paper or the amount of gold which it represents, and are fully covered by gold. On such a basis, no structure of credit can be built and gold is immobilized to an unnecessary degree.

2. Reduction of Minimum Reserve Ratios. If economy of gold is to result from this concentration in the hands of the central bank, then the reserve policy followed by the banks must be directed to this end

[1] *Report of the Committee on Finance and Industry.*

also. As we have already seen, the tendency since the war has been directed against economy in this respect, since under a variety of pretexts, central banking minimum reserves have tended to increase in magnitude. It is, of course, inevitable that, in the absence of a gold circulation, gold reserves at the central bank should show an increase, since upon them alone depends the making of any necessary monetary adjustments. This function is performed, however, by the *working* reserve, that is, the surplus of gold held over and above the *minimum* legal reserve, so that the new position, while calling for an increase in the working reserve, cannot be used to justify the increase in the minimum reserve requirements which has occurred. In fact, by increasing the minimum reserve from an average of 33 per cent to 40 per cent and by enacting that this reserve must be held against sight liabilities as well as note issues, the effective working reserves of central banks have actually decreased. The purpose of the minimum reserve is largely to establish confidence on the part of the general public, and any attempt on the part of a single central bank to reduce its reserve requirements might have the effect of weakening confidence in the currency. By concerted action amongst a number of central banks, however, it should be possible to effect a reduction of current legal minimum reserve ratios, due regard being paid to the economic circumstances of the different countries

3. Reduction of Working Reserves. This aspect of the question is, of course, inseparably connected with the foregoing. It should be possible to arrive at a common understanding between central banks with regard to the proportion of gold held over and above their minimum legal ratios. In this connection it would be necessary to recognize that different countries would have different needs which are determined more by the extent of foreign trade than by the needs of domestic business. The essential point is that gold should be available for export in case of need, and the magnitude of this reserve will vary according as a country is predominantly agricultural or industrial, or whether it is a debtor or a creditor.

The United States of America, for example, needs comparatively little gold, because from its creditor position it would be able to check a gold outflow by very moderate advances in rates which would be followed by the usual repercussion upon security movements and trade. On the other hand, a country like Brazil needs a relatively large gold

reserve or gold exchange because it is a country which is mainly agricultural. Its exports are largely made up of coffee, a product subject to considerable variation from year to year on account of differences in the crop and the course of prices. Moreover, the country is heavily a debtor country. Therefore, no possible increase in discount rates and other lending rates in Brazil could be relied upon to check an outflow of gold due either to withdrawals of foreign capital or to a shrinkage in the value of exports. [1]

This basis of economic need, however, does not govern the gold reserve policy at the present day. It has been shown, for example, that between 1925 and 1929 the average amount of Great Britain's gold reserves per head of her population was £3·3, that of the United States was about £6·7, whilst that of France was £6·1 in 1928 and £8·0 in 1929. The credit systems of the last two countries are little inferior to that of Great Britain, and such difference as may exist certainly does not justify this discrepancy. Hence there is ample scope for reform in this respect.

4. Development of Credit Facilities. A further recommendation leading to the economy of gold consists in the extension of facilities for payment by cheque, post office banking services, and by developing and improving the mechanism of clearings. In some countries, for example, the stamp duties on cheques act as an obstacle to the development of deposit banking, by restraining people from opening current accounts. It will not, however, be sufficient to provide the facilities and remove any legal restrictions. The general education and intelligence of the mass of the people is an important factor in the development of the "banking habit." Men do not use banks unless they have confidence in them, and they have come to be regarded as a settled part of the ordinary commercial mechanism of the community.

The explanation of the defective working of the gold standard which is based upon the alleged mal-distribution of gold stocks has a stronger basis of support than the gold scarcity theory. The present distribution of gold amongst the different countries is far from satisfactory and undoubtedly acted as a powerful factor in causing the price slump of 1929–32. None the less, there is no satisfactory evidence that the mal-distribution of gold was the initiating force giving rise to the slump. In actual fact, the concentration of gold

[1] Dr O. M. W Sprague, *The Working of the Gold Standard under Present Conditions* (Proceedings of the Academy of Political Science).

became much more marked after the commencement of the depression, so that it would appear to be an effect which has aggravated the position rather than a cause. Further, although there were fairly big movements of gold to Paris and New York in the early months of 1929 preceding the collapse, the slump did not come from England and Germany, which were losing gold, but from America. The depression set in after the Wall Street stock market crash in October, 1929. The Macmillan Committee ascribed the cause of the existing distribution to the instability of post-war international finance, especially to the irregularity of the flow of credit between the debtor and the creditor countries. Hence the problem of correcting the existing mal-distribution lies in the removal or mitigation of the underlying causes which have led to the present concentration.

STABILIZING THE PRICE LEVEL. It is now being realized that if we are to avoid the economic dislocations and setbacks, with their attendant social and political friction which price fluctuations entail, we must devote our attention to measures for the stabilization of the general level of prices There is considerable misconception as to what is meant by stability of prices, and many have construed the expression in the sense of an absolutely rigid system. To achieve such a position is an utter impossibility, since nothing can eliminate short-period fluctuations in the general price level, whilst still less is it possible to stabilize the prices of individual things. The ordinary play of market forces will always cause fluctuations of this nature.

> It is not the object of stabilization to eliminate entirely short-period fluctuations at all Nor is it supposed that much harm will result from permanent differences in the purchasing power of the monetary unit over a long period such as a century But the evils arising in our very complex and international civilization from large changes in the purchasing power of money in periods lasting, say, several years, up to a generation, are now so important and indeed critical, that we are forced to give serious consideration to them, whether we can ultimately prevent them altogether or not [1]

In the course of this search for a more stable price level, the working of the gold standard, which forms the basis of the monetary systems of the principal countries of the world, has been the object of considerable criticism. The majority of schemes for price stabilization aim, therefore, at the control of currency by some means

[1] Sir Josiah Stamp, "A Stable Price Level" in *Lloyds Bank Monthly Review*.

other than through the gold standard Moreover, since the abandonment of the gold standard by the majority of countries during the last three months of 1931, an additional incentive has been given to the formulation of schemes of monetary reform. Many of these are revivals or variations of ideas which have already been put forward by monetary reformers and are designed to effect a more or less revolutionary change of a permanent character in our monetary system. Others are put forward as temporary expedients of uncertain duration, having as their object an adaptation of the present position, and the evolution of a system by which the world can carry on its business pending an economic reconstruction which will allow us to revert to some form of gold standard.

CURRENCY REFORM. It is now proposed to examine, very briefly, the salient features of a number of the more important schemes of currency reform which have been put forward in recent years.

Managed Currency. In the first place we have the managed currency proposals put forward by Mr. J. M. Keynes, who has condemned the gold standard as a " barbarous relic." An inconvertible paper currency would be put into circulation, and note issues strictly controlled with the object of adapting the currency to the needs of trade. Commencing with the assumption that we cannot have stability of the internal price level and stability of the foreign exchanges, but must be prepared to sacrifice the latter in order to obtain the former, Mr. Keynes considers that a sound scheme must provide—

(1) A method for regulating the supply of currency and credit with a view to maintaining, so far as possible, the stability of the internal price level; and

(2) A method for regulating the supply of foreign exchanges so as to avoid purely temporary fluctuations, caused by seasonal or other influences, and not due to a lasting disturbance in the relation between the internal and the external price level.

In the final analysis, the level of prices under the existing system depends to a considerable extent upon the policy pursued by the Bank of England. Hitherto it is argued that the stability of exchange has been the object rather than stability of internal prices. This policy should be reversed and the Bank should stabilize internal prices by regulating the Bank Rate in accordance with an objective standard of value in the shape of an official index number,

This would register the price of a standard composite commodity, and the authorities would use all the means at their disposal to prevent a movement of this index outside certain limits from the normal.

This proposal has met with a large amount of criticism. It has been feared that such a plan would open the door to political interference in monetary affairs—a sphere where such interference has been almost invariably attended by disaster. Another serious objection lies in the nature of an index number which, after all, represents only an average. This may remain steady whilst its components undergo considerable changes, for, as Mr. Hartley Withers says—

> Steadiness in average prices is quite compatible with violent fluctuations in the price of any particular commodity. For instance, it would be possible for a very rapid advance in wheat to be balanced by a very heavy fall in iron, and for the index number to remain absolutely stable while these violent fluctuations were taking place in two important commodities. To those engaged in industry it is not enough to know that there is going to be little or no change in the general average of prices What they want to know is what is going to happen to the particular commodity which they produce or in which they deal.

On the other hand, as Mr. Keynes points out, gold itself has become a "managed" currency in the post-war period, though it is to be feared that the rules according to which it should be managed have been but little appreciated. The Macmillan Committee concluded that it was no longer advisable to regard our monetary system as an automatic system, producing the right result by the operation of natural forces aided by a few maxims of general application. The collapse of the system which followed almost immediately after the Committee had presented its report brought the conviction that it is better to dispense with a gold standard completely than to be on a gold system which is mismanaged. In fact, as Mr. McKenna has pointed out, the delusion that the gold standard operates automatically is, in a certain measure, a cause of our difficulties inasmuch as it has induced among monetary authorities a false sense of security, leading them to limit management to the irreducible minimum.

In consequence of recent events there is now a strong body of opinion which holds that the day of *laissez faire* in monetary matters is gone for ever. What is not so clear amongst those who are

inclined towards this view is the question of how, and to what extent monetary management is to be applied. For example, Mr McKenna has put forward the opinion that for some time to come we cannot hope to operate any system with success other than a pure managed currency without a gold basis On the other hand, he argues that there are undeniable advantages in a well-managed gold standard, but unless we can have such a standard, soundly managed by international co-operation, then we must definitely abandon gold and rely on a managed standard without any metallic basis at all. Hence, in his view, gold is still the most desirable basis for our monetary system, but it must be subject to skilled and resolute monetary management.

Other writers are prepared to discard gold altogether, either because they can see no immediate prospect of a workable gold standard system, or because they are convinced that gold can never give the requisite degree of stability. Thus Professor J. R. Bellerby considers that it would be flying in the face of Providence to link up with gold once more. He describes it as—

> A system under which the amount of money circulating in the country depended on how much gold we could dig up in South Africa and bury again under the Bank of England If the mines began to fail, we went short of money. If France or America pirated the gold on the way, we went short again It was a system that depended on the financial whim of sixty nations, coupled with a continuous succession of acts of God—on purely providential discoveries of gold.

Fluctuations in the general level of prices can be eliminated only by so managing the currency that it corresponds, not to the amount of gold or any other metal used as a standard of value that may be lying in the vaults of a central bank, but to the amount of reasonable transactions for which it may be required at any given moment. The ideal to work for is a world in which local currencies have a stable purchasing power, and at the same time are exchangeable into other currencies at a stable rate. Yet, it certainly seems legitimate to ask whether, in view of our failure to manage a gold standard and our lack of appreciation of the difficulties involved, we can hope to achieve success with the more difficult task of a managed paper currency. Again, as pointed out above, a position of absolute monetary stability cannot possibly be achieved. Mr. Keynes himself, in his latest work, has conceded a number of

limitations on the power of the banking system to control the price level—

(*a*) It is much easier to preserve stability than to restore it quickly, after a serious state of disequilibrium has been allowed to set in Thus, if we are asked to start control operations in a situation which is already unstable, we may find that the position has got, for the time being, beyond effective control.

(*b*) Granted all reasonable intelligence and foresight on the part of the managers of the monetary system, non-monetary causes of instability may sometimes arise so suddenly that it is impossible to counteract them in time In this event it may be inevitable that an interval should elapse before stability can be restored

(*c*) If there are strong social or political forces causing spontaneous changes in the money rates of efficiency wages, the control of the price level may pass beyond the power of the banking system.

(*d*) If a country adheres to an international standard and that standard is itself unstable, it is, of course, impossible to preserve the stability of the domestic price level in face of this [1]

Sterling Pool. After the widespread abandonment of the gold standard in 1931, the exchange rates of a number of countries on a paper standard have shown a tendency to approximate to their normal parity with sterling In order to overcome the disadvantages of a large number of independent local currencies, it has been suggested that all the countries which have left the gold standard should endeavour to reach an understanding, and make arrangements under which they would maintain both the stability of their purchasing power and their local currencies, and stability of their mutual exchanges In other words, there would be created a currency union based upon sterling, and facilitating international exchanges of goods and services between the members of the group. In the absence of an international gold standard, such a system would possess for London certain advantages It would tend to conserve the position of the sterling bill as an international medium of payment and would protect the financial prestige of London in a certain measure.

The present existence of the pool is largely an accidental development so that, in effect, London gains such benefits as arise without incurring any new responsibilities. It is more questionable whether the creation of a sterling pool should be made a matter of deliberate policy, since this at once raises all the difficulties of bringing about

[1] *A Treatise on Money*, Vol. II.

concerted international action. Such a system would impose a certain measure of control from London upon the participants, and it is somewhat questionable whether the self-governing Dominions, who would be prominent members of the system, would be prepared to subordinate their interests in order to comply with a policy laid down by London. Apart from this, London itself would have to order its financial affairs in accordance with the needs of the union, and it is always possible that such a course would conflict with our interests. As a temporary expedient the scheme has the merit of keeping open the channels of international trade, that is, so far as they are not completely choked by tariffs, but as a permanent policy it is too precarious to offer an assurance of stability.

Professor Lehfeldt's Scheme. This plan attacks the problem from the side of the supply of gold, and suggests that a syndicate could control the world production of gold. It could then adjust supply to demand and smooth out price fluctuations. For this purpose, information on the following points would be collected—

1. Monetary and banking statistics of all countries.
2. Information on the exploitation of all known sources of gold.
3. Statistics of prices in selected markets.
4. Condition of mining companies.

As the author of the scheme points out, private syndicates have successfully controlled the output of other minerals, notably diamonds, so that it should not prove an impossibility for an international syndicate to do the same in respect of gold, more especially as the economic life and well-being of the world are at stake. Again, the syndicate would not have to be a large one in order to achieve its purpose, since more than four-fifths of the world's gold production originates from the British Empire and the United States.

The aim of the syndicate would be to anticipate changes in the value of gold and to correct them by intelligent action. This might be done in times of rising prices by closing some of the least productive mines and paying compensation to the owners. In this way the supply of gold would be checked. On the other hand, when the production of gold became insufficient and prices tended to fall, the syndicate would stimulate production in every way possible by opening up new deposits and by the encouragement of research into improved methods of gold extraction. This plan possesses the

advantage of retaining the gold standard with the attendant confidence which it stimulates amongst the majority of men.

Tabular Standard. This aims at the abolition of a single commodity as the standard, and takes in its place a tabulated group of commodities in the form of an index number. The former medium of exchange is still employed, but is used in conjunction with the tabular standard. The system attempts to avoid the injustice which arises at present between debtors and creditors on account of rapid price changes. Under a tabular standard, debtors would be required to pay creditors an amount of control over commodities equal to the amount they have borrowed. For example, if the level of prices of the tabulated commodities advances 10 per cent between the time of making a loan and its payment, 10 per cent more in money is paid by the debtor to the creditor.

The first and most obvious objection to this proposal arises as a consequence of the uncertainty of the best method of computing a suitable index number on which the tabular standard must be based. Even if this objection could be overcome in such a manner as to give justice to all classes, there would still remain a resistance on the part of the general public to using such a cumbersome standard, since all transactions in terms of money would have to be translated into the tabular standard. Furthermore, as Professor Taussig points out, all transactions involving postponed payments would become uncertain—

> No man would know, when contracting a debt, what he would be called on to repay when it became due. He would have to watch each monthly or quarterly report of the index number bureau, and guess in the meanwhile how his affairs would have to be adjusted It is true that, as things now are, there is uncertainty; since there are changes in the prices of the particular things which each person buys and sells. But every one in business necessarily watches these changes and adapts his doings from day to day to the shifting conditions, indeed, so to watch them is a main part of business. To add to this inevitable cause of uncertainty another, from unpredictable changes in index numbers, would make all industrial operations irregular and halting.[1]

Supposing, however, that people were prepared to accept such a standard, there is still no guarantee that it would confer a greater measure of justice than the existing system. When prices fall because of changes in the productive efficiency of society a tabular

[1] *Principles of Economics*, Vol I.

standard does not subserve perfect justice. A lends B £1,000 now, and this amount of capital is capable of producing *x* quantity of goods; in forty years' time, when the loan is due for repayment, the same amount of capital will produce *y* additional goods, owing to the progress of the arts of production. Now, under a tabular standard, B would repay a sum of money yielding a product of *x* goods and retain the additional product—*y* goods—for himself. Yet, in so far as the improved yield of capital is not due to the efforts of B, he has no more moral right to this surplus than A. Hence, even on the score of justice, the tabular standard is not satisfactory.

Compensated Dollar. This plan, which has been advocated by Professor Irving Fisher, again rests on the use of index numbers. Gold coins are to be abolished and " gold bullion dollar certificates " issued, entitling the holder to dollars of gold bullion of such weight as may be officially declared from time to time. A 100 per cent reserve of gold is to be maintained against these certificates. An ideal composite " goods dollar " is to be constituted, consisting of a representative assortment of commodities worth a dollar at the outset, and an index number established for recording at stated intervals the market price of the composite goods dollar in terms of the gold dollar. The weight of the gold bullion dollar is to be adjusted in accordance with fluctuations in this index. A serious drawback of this plan is its unfamiliarity, and the majority of men, who are unused to the complexities of economic statistics, would find nothing but bewilderment in such a standard. Again, the plan is by no means consistent with the plans which are being formulated for economizing gold, since the 100 per cent gold backing is as wasteful as a gold coin circulation. The plan depends essentially upon a system of control operated through index numbers combined with a paper circulation so that, apart from psychological reasons, it would not appear unreasonable to expect that a bank capable of managing such a system would go a step further and introduce a pure managed currency.

The effects of the scheme upon the foreign exchanges would be very difficult to assess, but the varying gold content of the unit of account would create instability. It is, in fact, extremely doubtful whether a country could operate such a system alone, but the chances of its introduction on an international scale are remote in

the extreme. Further, on account of the limitation of the supply of gold, it is certain that it could not be adopted internationally without serious modification.

SILVER AND BIMETALLISM. The breakdown of the international gold standard in 1931 has revived once again the silver question. As a monetary metal, silver has become increasingly unpopular of recent years and, as one country after another linked itself up with gold, more and more silver has been thrown on to a market in which there was little or no demand for it. Upon the resulting depression of price there has been imposed a further fall in value on account of the appreciation in the value of gold. Now, although the western world rejected silver as a basis for its currency, the metal still retained its old importance in the East. China uses silver in all her transactions, not only as a store but also as a measure of value. In India, again, although the currency has been stabilized in relation to gold, enormous reserves of purchasing power have remained hoarded in silver. The fall in the value of silver has affected nearly a thousand millions of persons

Now there is a large section of public opinion which still holds that the world's monetary psychology demands that currency and credit should rest upon a tangible metallic basis. Gold, it is argued, has not provided a basis of sufficient stability, so that the best way to preserve a metallic standard would be to widen the basis of currency and restore confidence in silver, especially in the East, by re-introducing it into the world's monetary system. Without going to the length of remonetizing silver as currency, or making it legal tender at a definite and permanent ratio as under a bimetallic system, it would substantially increase the amount of gold available as well as keep up silver prices, if central banks could arrive at a common agreement to keep a percentage of their metallic currency reserve in silver at market price. The large fluctuations in the value of silver in recent years have been due mainly to the action of central banks in excluding it from their reserves; by re-introducing it once more they would assist in the stabilization of its value.

Others are prepared to go further than this and consider that the ultimate solution will be found in a complete system of bimetallism. They look to international action to solve the age-old difficulty of the bimetallist, that is, the adjustment of the ratio of value of the two

metals. Alternatively, the central bank could manage the values by having the option which metal it would buy or sell at any time. International action and agreement is slow and, having broken down over the more simple gold standard, we cannot feel unduly optimistic over a more complicated system. Moreover, in the existing condition of things, it is not sufficient to broaden the basis of our metallic standard. The forces which caused the breakdown of the gold standard are capable of wrecking any other unless proper precautions are taken. If such measures of reform are adopted, then gold can be made to serve the monetary needs of the world without further assistance.

TEST PAPER 2

1. Explain why, in civilized communities, gold has superseded other kinds of money as the standard of value
2. What do you understand by the gold standard? Examine its advantages and disadvantages in the light of what has happened in this and other countries since 1914
3. Show the use of gold in the conduct of international trade
4. "The international gold standard creates, not a common price level, but an integrated price-and-income structure, the various parts of which stand in an organic relationship to one another." Explain this quotation.
5. To what extent does the existence of a gold standard guarantee the stability of prices?
6. What do you understand by the policy of deflation? Explain how certain classes benefit and other classes lose when deflation takes place.
7. In what respect does the gold standard at the present time differ from that which existed in pre-war days?
8. What was the result of the passing of the Gold Standard Act of 1925?
9. Distinguish between (*a*) a gold bullion standard, (*b*) a full gold standard.
10. What is meant by the gold exchange standard? How does such a standard lead to economies in the use of gold?
11. "The post-war gold standard has worked in a manner quite different from that of pre-war days, and in many respects, in a manner much less satisfactory." Explain and elucidate.
12. Account for the financial world crisis of 1931.
13. Explain the meaning of the following quotation: "Depreciation of the pound sterling will enable British exporters for a period to cut their selling price in foreign markets Britain felt the effect of this truism when the mark collapsed in Germany, the franc in France, and the lira in Italy. But the thing cuts both ways."

14. Analyse the causes of the scarcity of gold. What suggestions have been made to obviate such a contingency in the future?
15. State precisely what you mean by the stabilization of the price level?
16. How does a general decline in prices affect—
(a) The wage earners; (b) Salaried earners, (c) The investing public; (d) Those engaged in business? Illustrate from post-war conditions, in our own and any other country.
17. "It matters very little whether prices are 'low' or prices 'high' in the long run It is the change from one level to the other that works injustice and introduces disturbing factors into business." Examine this statement.
18. Examine the salient features of any scheme of currency reform which has been put forward in recent years.
19. Write explanatory notes on the following—
Managed currency, sterling pool; tabular standard; compensated dollar.
20 Indicate the characteristics of bimetallism and contrast it with a mono-metallic standard
21. Criticize the suggestion that the use of gold as a medium of exchange involves a corresponding loss of national wealth which might be saved by replacing the metal by tokens.

CHAPTER III

Nature and Significance of Credit

It is a feature of the present industrial system that the production of wealth tends to take place in economic units, the size of which is continually increasing. This characteristic of economic organization calls for larger concentrations of capital in the hands of those who control business enterprise, since the larger the scale of the undertaking, the greater must be the capital investment. This demand for a greater concentration of capital in consequence of the scale of business enterprise has been reinforced by another tendency the influence of which is manifest in large and small-scale industries alike. This arises from the increasing mechanization of industry which has resulted in a greater employment of fixed capital in the form of plant and machinery, with a slackening in the demand for working capital to pay wages. All these modern developments rest essentially upon the fact that producers are not called upon to furnish the required capital themselves, or even any considerable part of it, but are able, through the services of a variety of credit institutions, to obtain the disposal of borrowed capital.

It is a characteristic of existing large-scale enterprise that the capital required for its development is provided by a large number of people in relatively small amounts. Furthermore, there would appear to be a tendency, in some sections of the business world at all events, for the *ownership* of such capital resources to be divorced from the *control* of these resources in production. It is obvious, therefore, that some connecting link is necessary between those who own resources which are seeking employment and those who can use them to advantage in economic production. This link is provided by the system of credit and the many institutions which are based upon it.

CREDIT AS THE POWER TO BORROW. The term credit is used in a number of different senses, but it will be sufficient for our purpose to consider the two most important. It is incontestable, however, that the essential basis of all credit transactions is the confidence which exists between the borrower and the lender, that is

confidence in the ability of the borrower to refund what he owes together with any agreed interest payments, and also in his willingness to make such payments. According as lenders have confidence in a person or institution, we may say that its credit is good or bad In this sense, therefore, credit may be defined as the power to borrow, and, using the term in this sense, Lavington says—

> Credit seems to be *a condition which enables a person to extend his control, as distinct from his ownership of resources* . . Credit is a *condition*, a condition which may be expressed on the one side as the power of business men and others to borrow from capitalists, and on the other as the confidence on the part of the investor in the person to whom he entrusts his capital The confidence of the investor and the power to borrow of the business man are two aspects of the same condition, a condition which enables capital to move easily from one to the other [1]

This confidence, upon which the power to borrow depends, is at best, a very elusive quantity We know, for example, that certain states can borrow more easily than others. Thus the British Dominions can, in general, borrow on more favourable terms than many of the republics of South America. The power to borrow possessed by a state is influenced by the nature and stability of its political institutions. Any country where frequent changes of government occur as a result of unconstitutional methods such as revolution, cannot command the confidence of the investor. In such circumstances, even though a change of Government may not be followed by a repudiation of indebtedness, the resulting repercussions are liable to impair its ability to repay what has been lent. Again, the country's financial record in the past is of considerable importance; some countries have exercised little or no control over their borrowing powers, new loans being floated from time to time as additional capital was required, regardless of ability to meet interest charges.

Over and above stability of political institutions, the general economic organization of the country will also influence its power to borrow. A state which has become economically dependent on one industry or one commodity will experience ebbs and flows of prosperity according to the fortunes of the industry in which it is interested. This again tends to undermine the confidence of investors. In the case of Brazil, for example, there is a strong element of

[1] *The English Capital Market*

speculation in the economic position of the country Coffee represents more than 70 per cent of the total Brazilian exports and, in addition, is estimated to be responsible, directly or indirectly, for an equal percentage of her financial revenue. Coffee provides the sterling and dollars required for the services on foreign loans Since the demand for coffee is more or less constant, with a fixed tendency to increase, and the supply, which depends on harvests, rain, frosts, and winds, is not constant, the market has been subject to violent oscillations which have reacted on the financial stability of the whole state

Again, the credit of a state or of the people residing within its boundaries will depend in no small measure upon the state of the law relating to borrowing and lending, as well as the readiness with which contracts can be enforced. For example, to take the case of Brazil once more, the lax state of the law of bankruptcy has created a position where it is extremely unsafe for a foreign merchant to sell on credit. The Brazilian merchant only too frequently trades with insufficient capital and, if he becomes insolvent, his assets are swallowed up by the local creditors, who are in a position to enforce their claims with greater effect than a foreigner. The latter, therefore, often finds himself compelled to consent to a settlement of a small fraction of the total indebtedness whilst the defaulting trader can once more establish himself in business. Such laxity on the part of legal institutions destroys the basis of confidence upon which credit is founded.

Very similar considerations apply in the case of different industries in the same country Those which possess the greatest power to borrow are those which can show the greatest progress as measured by profits. An industry which is "depressed" and is not earning profits, rapidly loses the confidence of the investor and finds that its credit is seriously impaired. The iron and steel or cotton industries in this country, for example, are in such a state Their economic organization is defective, yet they do not possess the capital or the power to borrow it, so as to reorganize. On the other hand, the motor industry or certain branches of the retail trade, possess this power because of their prosperous condition which commands confidence.

CREDIT AS A TRANSFERENCE OF PROPERTY. In the course of the foregoing discussion we have considered credit as the power of

borrowing which a person or an institution possesses. Alternatively, however, it may be regarded as the actual exercise of this power resulting, it may be, in a loan or in a change in the ownership of goods in anticipation of payment in the future. In either case there is a transference of property. There is a present transfer in the control over resources in exchange for control over resources in the future.

One of the most simple examples of this type of transaction is that of ordinary trade credit which is so extensively employed in the distribution of goods. Trade credit involves the transfer of commodities now in return for an undertaking to pay an equivalent value in the future The process of distributing goods from the primary producer to the ultimate consumer involves the services of many intermediaries, many of whom both buy and sell goods on credit. Thus, in their passage, the goods call into existence a long chain of debts or trade credits, since a debt and a credit are but different aspects of the same transaction according as it is regarded from the standpoint of the borrower or of the lender.

The extent of the dependence upon credit varies with different trades according to their economic characteristics. Those industries engaged in the production of capital goods usually place a greater reliance upon credit than those providing consumption goods In constructional engineering and shipbuilding, for example, long-period credits are often necessary, so that it frequently happens that the business will go to the concern which can offer the greatest concession in this respect. Again, the wholesale trades transact a much greater volume of business on credit than do retail dealers, although in the latter case big changes have occurred in recent years with the development of hire purchase and instalment trading systems. Indeed, it has been said that—

> The development of credit trading and hire purchase systems has rendered it still more difficult for smaller traders to compete with the larger undertakings who are operating on a credit basis. In order to enter this particular field of competition, traders in a comparatively small way of business are compelled to seek assistance from financial corporations or societies who buy hire purchase agreements, or advance money upon them.[1]

[1] *Minutes of Evidence taken before the Committee on Finance and Industry* (Vol II). Statement of evidence submitted by the National Chamber of Trade.

This spread of credit trading in the retail trade has even penetrated to the co-operative movement, which has always condemned it. Although the movement has been forced into adopting a system of credit trading by outside competition—by way of instalment buying and club trading—opinions as to its merits are divided. One section favours it because it has led to a considerable expansion of co-operative trade, whereas the other section fears that the development may be in the wrong direction, and lead people to buy things which they cannot afford. None the less, although credit trading may have vicious results if carried to excess, it can also confer great benefits if utilized under proper control.

The other principal type of credit involving an actual transference of property arises when the control over a stock of purchasing power in the form of money is transmitted from one person to another. In this case we have what is usually described as loan credit, which is possibly the most common form of credit business. Even in this case, of course, the ultimate outcome of the transaction is the purchase of goods of some description, but the immediate transfer is performed in terms of money. Such loan credit appears in the balance sheet of the borrowing concern amongst the liabilities under such headings as mortgage loans, debentures, or bank overdrafts.

FORMS OF CREDIT. A number of different classes of credit are commonly recognized, the basis of distinction between them usually resting upon the source of demand. Yet, though we may for purposes of convenience recognize a number of different classes, it is not possible to draw any hard-and-fast line of distinction between them.

1. Producers' Credit. This form of credit includes all the loans which are raised by the entrepreneur with the object of expanding production. Within the term "production credit" a differentiation may be made between credit utilized for the purpose of the acquisition of fixed assets and that which is used as circulating capital. In the first case we have what is usually described as investment credit, where the capital obtained is sunk permanently or for long periods of time in such assets as plant and machinery, buildings, factory sites, ships, and so on. From the diversity of objects for which such credit is used it follows that it can be repaid only over a long period

of time, since its productive effect is spread over a large number of uses. In fact, in many cases, it is not intended that this credit should be repaid at all by the undertaking making use of it, since, as in the case of share capital, there exists no right to withdraw any holding of capital except in the event of a liquidation

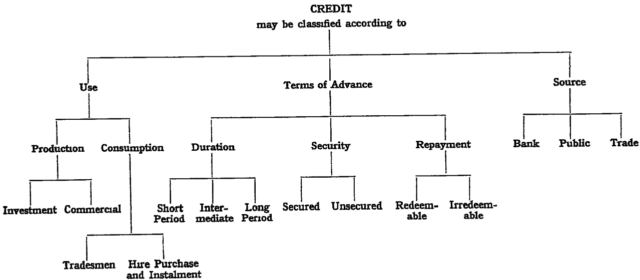
The second form of producer's credit, commonly called commercial credit, is the type which is used to finance the operating expenses of a going concern. It is the means whereby a concern "pays its way"—

> If receipts and expenses always kept pace, the problem of finding the means of payment would solve itself. The receipts would be applied to the expenses, and the profit retained as income. . . . In practice the receipts and expenses of a concern do not exactly keep pace This may be expressed by saying that its needs for working capital vary from time to time. It needs more working capital, for example, when its output is increased, or when its receipts are delayed, less when its output is diminished or its receipts are hastened [1]

The greater part of production takes place in anticipation of demand so that even when a somewhat protracted process of production is completed the finished article has yet to find a market Even when it has been sold and the purchaser has taken possession of it, some time may elapse before the purchase price is paid in money. In the meantime, however, the producer must carry on his operations. His employees will require their wages week by week; he will have to pay his suppliers for the raw materials which he has purchased, meet bills for repairs and renewals, and pay for such services as transport and advertising. Periodically, too, the local and central government authorities will make demands upon him for the payment of rates and taxes. Commercial credit is employed to fill this gap, which arises mainly because expenses and receipts rarely coincide either in time or in amount

Commercial credit offers the means for obtaining the necessary working capital wherewith these operations may be financed. Furthermore, in so far as stocks of goods are constantly being liquidated and converted into cash, such loans are required for short periods only. Unlike the demand for capital equipment, the requirements of a business for working capital are subject to fluctuations at different times. Most businesses show a certain degree of "seasonal" activity, so that their demands for working

[1] R. G. Hawtrey, *Trade and Credit*



Credit may be classified according to the use which is made of it, the terms upon which it is advanced, or the source from which it springs. This basis of classification serves the purpose of convenience, though the divisions overlap to some extent. Credit is, broadly speaking, employed either in the finance of production or of consumption. In the former employment it may take the form of investment credit embodied in plant and fixed assets, or commercial credit in the form of circulating capital. Consumption credit may assume the form of the informal book debt to a tradesman, or the more formal hire-purchase agreement.

The terms upon which credit is advanced usually embody an agreement as to the duration of the loan, the security, if any, which is to be deposited, and the time of repayment. Credit may be advanced by banks and financial institutions, or by trading and industrial concerns.

capital to pay wages and so on will obviously be greater at some times than at others. Thus, manufacturers of agricultural machinery make the bulk of their sales of tractors and threshing machines in the summer period prior to the commencement of the harvest. In this industry, therefore, the working capital position is complicated by the fact that expenses are greater than receipts for eight months of the year, this condition being reversed for the remaining four months. In such cases as this a trader who possesses sufficient capital to finance his business through the period when no sales are being made, finds himself with a large surplus during a period of active trade. This surplus may be invested outside the business in the form of short-term loans which may be liquidated as additional funds are required. Alternatively, a business may possess sufficient working capital to meet its average requirements and then employ the credit of the concern to borrow any excess which may be required at a time of special strain.

2. Intermediate Credit. As pointed out above, the financial problem of every undertaking is twofold, namely, to provide itself with adequate permanent capital and also a sufficient supply of working capital to finance production and market distribution. Of recent years there has arisen a demand for additional credit facilities of an intermediate character for the purpose of financing certain special types of business. Intermediate credit may be defined as that advanced for periods ranging from one up to five years. This type of credit appears to be necessary in such transactions as hire-purchase sales, sales under a system of deferred payments, and in respect of long-term contracts.

The need for credit of this type is especially urgent in the case of those firms engaged in overseas trade. Particularly since the War, overseas buyers have shown a tendency to demand credit facilities of a more extended character, and keen competition for business has enabled them to obtain such concessions. The overseas trade in agricultural machinery is a case in point. Manufacturers are now compelled, by force of competition, to maintain overseas selling branches with permanent stocks, but it takes on the average six months from the date of shipment from the United Kingdom before sales from such stocks can be effected. Conditions of sale, however, do not usually require any payment on account upon

delivery of machinery. Deliveries are usually made to dealers several months in advance of the season, whilst frequently payment extends over two harvests A crop failure, which cannot be foreseen at the time of shipment and often not even at the time of sale, invariably involves extensions of payments. To finance this long period of credit requires resources greater than those possessed by the majority of manufacturing firms, and in consequence assistance has to be given by special financial institutions.

8. Consumption Credit. In the case of producer's credit the loan, together with any interest payments, will usually be paid out of the income derived from the productive use of the borrowed funds. In the case of consumption credit, however, the loan cannot generally be refunded in such a manner, since the goods which are purchased by it are used in final consumption in the satisfaction of human want. Hence, such a loan must be repaid out of income which is drawn from other sources. As we have already seen, the use of consumption credit has extended over a very wide field in recent years through systems of hire purchase and instalment trading. This is a system of trading under which there is an extension of credit to purchasers, under some form of contract, by which the purchaser agrees to make partial payments at stated intervals over a period of time. It is usually applied to those types of articles which require a comparatively large outlay, although of recent years the number of articles falling within the scope of the system has been enormously extended. In the United States, for example, and to a smaller extent in this country, it has assumed such proportions that half the motor-car sales are effected on this basis, and a great number of other articles such as furniture, pianos, wireless sets, sewing machines, gramophones, washing machines, and electrical household appliances, depend upon it for a large part of their trade.

The provision of consumption credit of this type has assumed an increasing importance in this country, although the volume of business is still small as compared with the United States. The system is by no means new—the Singer Sewing Machine Company introduced it for the sale of its goods about 1850—but until comparatively recent times instalment credit was of ill repute. Its recent growth may be attributed, to some extent, to the increased real income and higher standards of living of the working classes

since the War These have caused the worker to interest himself in a wider range of articles. More important than this, probably, has been the development of mass production methods in a number of industries. These can be applied only where there exists a wide market, so that all manner of devices are employed to stimulate consumption. Of these devices, instalment credit is one of the most attractive. The superior development of the system of instalment credit in the United States is probably due, in great part, to the creation of special financial machinery for the provision of credit of this class. The financing of instalment sales requires a large amount of working capital, not only on account of the actual outlay but also on account of the administrative cost. There now exists in the U.S.A. a group of more than 1,000 finance companies which purchase the consumers' contracts from manufacturers and dealers, employing for that purpose funds of their own and resources borrowed from the banks, thus relieving the manufacturers and retailers of the burden of credit. These companies have their own legal staffs who have drawn up standard forms of contract, they have elaborate schedules of charges which vary with the size of the initial payment and the duration of the contract, and they have developed highly effective collection systems. A few manufacturers, such as certain of the motor manufacturers, have founded subsidiary companies to perform this work of instalment credit finance. So far as Great Britain is concerned, a small number of finance companies are now in existence, whilst even the great joint-stock banks no longer refuse to deal indirectly in this class of business.

The banks, in the ordinary course of providing direct accommodation to their own customers, probably provide a considerable part of the funds required for carrying on hire purchase business. This does not imply that the banks actually lend specifically for hire-purchase trade, but in the ordinary course of operation of their overdraft facilities, substantial sums, though unidentifiable in detail, are probably lent for this purpose. Similarly, the banks are called upon from time to time to lend large amounts to finance the operations of manufacturers, some of whom may be producing partly or wholly to meet the hire purchase demand In these cases again the banks are indirectly financing this particular type of business.[1]

The other type of consumption credit is ordinary book credit, where regular customers of a trader keep running accounts for

[1] *Midland Bank Review.*

purchases, the balance outstanding being settled at regular intervals, usually weekly or monthly. Practically every class of retail trader advances credit in this way to his regular customers, though its use is most general in the case of the common articles of domestic consumption, particularly foodstuffs. In many cases, credit facilities are used in this way more for the purposes of convenience than as a means for deferring payment until income is available. Credit of this type is, however, very much less systematic than instalment credit, and there is frequently no chance of regaining possession of goods upon a default in payment.

4. Public Credit. By public credit we mean the power of a government, whether national or local, to secure control over resources in return for its promise to pay in the future. As in the case of any other type of credit, the normal basis of public credit is the trust and confidence which public creditors have in the ability and intention of the debtor to pay interest and principal when due. Public credit cannot exist until an orderly government appears over which the mass of the people can exercise some measure of control. Under an autocracy, it is the personal credit of the ruling monarch which is involved, rather than the public credit of the state

There are, however, certain significant differences between public credit and that of a private individual. In the case of a national government, control over resources in the form of a loan may be obtained by compulsion—the state can force its citizens to lend to it in the same way as it compels them to pay taxation. This method of procedure was employed in its crudest form in the early history of public debts, and is rightly condemned as social and economic organization advances It is often tantamount to confiscation of property under the guise of a loan and is an abuse of public credit, since there can be no possibility of any confidence on the part of the lender. Although, under modern conditions, the open employment of the device of the forced loan is seldom found, it none the less exists in a much more subtle form. The currency inflation which occurred in most belligerent countries during the Great War amounted to a forced loan levied by the government. By such means it diverted the purchasing power of the population to itself

Secondly, unlike the private creditor, the state may refuse to repay the principal sum or make the interest payments on it. Thus,

during the trade crisis of 1931, a large number of states were compelled to declare a moratorium in respect of the interest payments on their loans. Again, a part of the liability to repay the principal may be evaded by repaying the loan in full, but in a heavily depreciated currency. When this occurs, the creditor receives an amount of purchasing power which is nominally equal to that which he originally lent, but which is very much lower in its real value. In all these cases the lender is usually without any means of redress, although the power of the defaulting state to borrow is correspondingly weakened in the future.

A third characteristic of the state as a borrower arises from the publicity of the facts relating to its financial standing A private borrower is, of course, under an obligation to make a full disclosure of his financial position before asking for credit, but since this is done only when he is seeking to borrow, he will endeavour to make the best possible case for himself. Even though he adheres strictly to the facts a certain amount of "window dressing" is almost inevitable. In the case of a state, however, the public has the records of its financial activity continually before it, and these are subject to critical examination in other connections. This publicity extends to the employment of the loan after it has been made, and thus the lender derives a certain amount of additional security from the pressure of public opinion.

The function of public credit is to provide a means for overcoming unforeseen and unusual financial difficulties. In an unexpected emergency such as war, it will not usually be expedient or possible to raise the additional revenue required by the imposition of new taxation. Hence, borrowing is the only possible method of providing immediate financial relief. Modern warfare, for instance, is so costly that no adjustment of the system of taxation is possible to raise the necessary funds, so that resort has to be had to an extensive use of credit.

5. Secured and Unsecured Credit. As already pointed out, the credit relationship is based essentially upon confidence, but in a large number of credit transactions the lender will require some more tangible security. Unsecured credit is granted where the credit relationship is based solely on the confidence reposed in the debtor and where the lender dispenses with any particular form of safeguarding

his claim. In other words, the creditor is satisfied with his own estimate of the financial status of the borrower. The only record of the debt consists in an entry in the books of the business or, occasionally, in a formal acknowledgment of the debt. Thus, a large part of ordinary commercial credit consists of unsecured credit in the form of book debts. This type of credit has the advantage of providing a quick and easy method of recording the transaction and, on account of its informal nature, tends to stimulate business with people who might hesitate to enter into a more formal transaction On the other hand, unless employed with caution, it may degenerate into credit of a dangerous type, since payment occurs through the voluntary action of the debtor, and no effective method exists of enforcing prompt settlement. Moreover, the book entry is not *prima facie* evidence of the existence of the debt, since it contains no acknowledgment of the debt by the debtor. Consumption credit obtained from tradesmen in the form of a running account falls in this category, in the case of instalment purchasing on hire purchase contracts, however, we have secured credit, since the creditor can resume possession of the goods in default of payment and may retain a part or the whole of the deposit paid.

In the case of secured credit the existence of confidence is not considered of itself to be adequate, but some additional protection is required. Security of a satisfactory character must in this case be deposited in order that the lender may not suffer loss in the event of a default by the debtor. Such security will be demanded in the majority of cases by the joint-stock banks, since these institutions owe a duty to their shareholders and depositors not to risk the funds entrusted to their care.

The banker provides the trader with the means of payment He himself creates the means of payment in the form of his own obligation But he cannot afford to perform this service indiscriminately for all comers The real significance of his insistence on security is that he will only transform some good asset possessed by his customer into the means of payment. The customer has a certain stock of wealth, which is not immediately saleable, he has to make certain payments, the banker changes a portion of this wealth for him into the means of payment. The wealth is, as it were, mobilized or liquefied.[1]

The type of security accepted varies widely and tends to vary with the class of business of the person seeking credit. Very frequently

[1] R. G. Hawtrey, *Trade and Credit.*

the customer will deposit stock exchange securities, life assurance policies, title deeds to land or buildings, or documents of title to goods. On the other hand, the security may be of a personal nature, and may take the form of a guarantee from someone of known substance. Again, in the sphere of agriculture, merchants and dealers will frequently advance credit to the farmer on the security of live stock or growing crops.

In granting credit on the basis of some tangible security, the creditor will usually take care that the value of the security deposited is ample to cover the amount of the advance. Hence, it is not the nominal value of the security which will be considered, but the probable market value Furthermore, the security must be such as will command a ready sale, otherwise there may be considerable difficulty in liquidating it in the event of a default on the part of the debtor. This factor is of vital importance in the case of a bank, since the bulk of its deposits will be payable on demand, so that the banker cannot afford to imperil the liquidity of his resources.

6. Redeemable and Irredeemable Credit. The use of credit implies the creation of an obligation to repay something of value in the future. The usual practice is that a fixed time shall be granted for the duration of the credit, to be arranged by agreement between the parties before the loan is made, or, if no time is specified, then the creditor will usually have the right to call in the loan at any time. Thus, in the case of a bank, credit may be extended for a definite period, upon the termination of which the debtor must refund the loan, or arrange for a renewal. Alternatively, a small fluctuating overdraft may be allowed to continue indefinitely, though it may be terminated at any time by the bank and the customer asked to repay the deficit. Such credits are termed redeemable, since provision has to be made by the debtor to repay them sooner or later.

In contrast to this, we may have irredeemable credit where the creditor has no right to repayment, but only to an agreed payment of interest. The initiative for repayment lies with the debtor. Thus a company may raise a loan by an issue of debentures which are repayable only upon the occurrence of an event which may never take place, such as the winding-up of the company or a default in the payment of interest. In other cases the debentures may be redeemable at the option of the company at any time, or at a

specified time after issue. In the latter case, the company may repay the loan on the expiration of the period or renew it.

The question of irredeemable credit is probably of the greatest importance in the sphere of public finance It is argued in favour of the irredeemable public debt that the annual burden is less, since there is no necessity for including sinking fund or amortization charges for its ultimate redemption. Again, if the initiative to redeem rests with the government, then it can always wait for a favourable time before action is taken to repay. On the other hand, if a government is obliged to plan for debt repayment at a definite date, greater care is likely to be exercised in the amount of obligations assumed It was emphasized by witnesses before the Committee on National Debt and Taxation, that debt repayment provided the best means of maintaining confidence, especially in bad times. Professor Pigou pointed out that—

> Other things being equal, the existence of a large National Debt to which no remunerative asset corresponds must weaken that confidence Given the size of the National Debt, a consistently maintained policy of providing for the service of the debt (including the gradual reduction of the principal by means of a Sinking Fund) must strengthen confidence.

A further disadvantage in the case of an irredeemable debt ensues from a fall in prices without a compensating increase in production. In such circumstances the money yield of existing taxes at current rates will fall, whilst expenditure for interest on the debt is not affected in terms of money. Therefore, the real annual burden of the interest charges increases in proportion to the fall in prices, with consequences which were seen only too clearly in this country between 1929 and 1932.

ECONOMIC ADVANTAGES OF CREDIT. It is through the mechanism of credit that there is provided a means whereby existing supplies of capital may be employed in the most advantageous manner In the first place, business activity is no longer restricted to persons who possess their own capital, but those having projects which can give remunerative employment to capital can, through the credit system, obtain control over such resources as they require. Joint stock undertakings, as a means for obtaining control over capital in relatively large amounts, existed even before the development of highly-organized credit institutions, but the difficulties attending the

collection of such large amounts of capital as are frequently required at the present day would be insurmountable were it not for credit instruments in the form of bonds, stock and share certificates. Instead of negotiating a tremendous number of small individual loans, the total sum required is divided up into a large number of equal units of small denomination, and these are sold to investors through the various institutions of the market.

Credit, then, ensures that capital will, on the whole, find more productive employment. He who possesses capital, without the technical knowledge or ability to make use of it, transfers it to another person, to the benefit of both, as well as to that of the community as a whole. It will be obtained, other things being equal, by the man who is ready to pay the highest price for its use, that is, in general, to the one who can employ it most productively. This is not, of course, invariably the case, for those in need of credit may require it for the purposes of speculation and may be prepared to pay such a high price for it that business interests are unable to obtain accommodation.

Again, in respect of working capital, credit institutions offer immense advantages to the producer and trader. As Mr. R. G. Hawtrey has pointed out—

> Credit is essential to the economic development attained in the modern world. If we imagine a community without the practice of borrowing and lending we must suppose every trader to be limited in the scope of his operations by the need to provide cash for all purchases. He must so conduct his business that the maximum need for working capital will not exhaust his resources, and the result will be that, when the need of working capital is at the minimum, he will be encumbered with a large balance of idle money. If he ties up too much of his capital in permanent investment in his business, he may miss lucrative trading opportunities for want of ready cash, or may even be involved in serious embarrassment through unforeseen losses.[1]

This difficulty in respect of working capital is particularly great in those industries where production is of a seasonal nature, such as agriculture, or where the market is a seasonal one, as in the case of coal mining. In these cases, working capital flows into the business in seasonal bursts, whereas the demand for it is comparatively steady. In the case of coal mining, for example, it is to the advantage of the colliery owner to keep his pits in a state of steady

[1] Article on "Credit" in the *Encyclopaedia of the Social Sciences*, Vol IV.

production all through the year, but the domestic demand for coal fluctuates widely as between the summer and winter months. If production is steady throughout the year, stocks will accumulate unsold during the summer, but cash will have to be found week by week to pay wages and other working expenses. The colliery undertaking, in order to work on this basis, will have to accumulate a large cash reserve pending the liquidation of its stocks, or, alternatively, find some institution which will furnish it with the requisite working capital. This function is performed by the wholesale dealer in coal, who purchases the stocks as produced and holds them for the winter demand. In this case, then, it is the wholesaler who provides the credit and, in so doing, performs a service of the greatest benefit to the colliery owner inasmuch as the latter is, by this assistance, enabled to produce continuously.

Again, the institution of credit effects considerable economies in the methods of payment, since settlement by cash is replaced by the passage of credit instruments whereby, through the medium of the banking system, one debt is set off against another and there is a general cancellation of indebtedness between the various business concerns. Thus, in speaking of one of the most important of these instruments of credit—the cheque—Mr. Lavington says—

> Cheques are by far the most efficient form of currency yet invented, and are especially adapted to make distant payments of large and irregular amounts. They are quickly "cleared" by an efficient system of central and local Clearing Houses They form a convenient record of transactions; their negotiability may be restricted in a manner which makes them practically valueless to anyone but the owner; and, finally, they may be adapted in amount to the needs of each particular operation. By means of cheques, bank deposits form, as it were, an *ad hoc* currency, a currency created in adaptation to particular payments as they arise [1]

The economies resulting from the employment of credit instruments, such as the bill of exchange, are particularly marked in the case of the payments in international trade. In this case, if it were necessary to dispense with credit instruments, great quantities of gold would be necessary to effect a settlement, so that much of the existing trade could not be carried on at all. Quite apart from this aspect of the question, however, were it not for the existence of

[1] *The English Capital Market.*

credit and the various institutions which administer it, foreign trade on its present scale would be impossible. If domestic trade had to be conducted on a strictly cash basis, that is, on the basis of the immediate transfer of equivalent values, its scope would be considerably restricted In the case of international trade, transactions of this kind, without the intervention of credit instruments, would destroy the basis of practically all trade, since transactions would be reduced to a basis of barter. Thus, during the trade slump of 1931–32 many European and South American governments imposed foreign exchange restrictions so that importers of goods were unable to obtain the means of payment by the usual credit instruments. In consequence there was a tendency throughout the world towards a "freezing-up" of international trade, whilst the various clumsy expedients which were resorted to for the purpose of relieving the situation were but a poor substitute for the normal mechanism of credit. Switzerland, for example, entered into an agreement with Austria and Hungary, under which the Swiss National Bank promised to make its own importers pay to it amounts due to Austrian and Hungarian exporters, those amounts being credited to the Austrian and Hungarian National Banks. The funds obtained were to be utilized partly for the purchase of goods in Switzerland, and partly for the repayment of Austrian or Hungarian debts due to Swiss creditors. Such an agreement amounts to a kind of barter of commodities and severely restricts the volume of foreign trade.

DANGERS OF CREDIT. Credit is, however, open to a number of abuses. Although differences of opinion exist as to the power of the banks individually to create credit in excessive amounts, there can be little doubt that the banking system as a whole can be the cause of an unhealthy expansion of credit facilities. The consequences of an unwarranted expansion of credit may manifest themselves in a variety of ways It may lead to an excessive investment of capital in one industry or a group of industries, thereby causing excessive competition with probably a loss of both revenue and capital in the industry. Further, it has been a frequent complaint of recent years that the banks have tended to be over-generous in their provision of credit to weak industrial undertakings. It is asserted that, on account of their interest in such undertakings, the banks tend to keep these weak firms in existence instead of allowing

them to go into liquidation, so that, in consequence, the process of industrial reorganization is delayed and stronger undertakings become embarrassed as well—

> An industrial crisis is in many ways like a ship-wreck In a shipping disaster, we do not speak of the survival of the fittest, for we know that it is not the strongest swimmers, but the weakest that find places in the boats. In an industrial crisis, it is the first firms that become involved that can secure the readiest assistance of the banks As the banks' funds become tied up, the later applicants, who are in fact the stronger, find assistance more difficult to obtain Once a firm has secured a seat in the banks' lifeboat, the banks frequently hesitate to throw it overboard to find room for another The indebtedness of a firm to a bank measures the bank's interest in its survival.[1]

Yet, it must be remembered that the banks have frequently to formulate their policies on very imperfect data, whilst the restriction of bank credit as soon as business experiences a set-back may easily precipitate a crisis which otherwise may never materialize Business firms are so closely linked up in a series of intricate debtor and creditor relationships that difficulties in one section of the industrial field spread with alarming rapidity to all other sections. Widespread disaster may therefore be averted by timely support before the basis of confidence is destroyed, though if this support is given indiscriminately or is too long withheld, the last case may be worse than the first. Again, apart from industrial investment, credit is frequently employed in times of boom for speculative purposes on the Stock Exchanges and elsewhere. Thus, the cheap money policy of the Federal Reserve System of the United States in the winter of 1927-28 initiated the stock market boom which culminated in 1929 in the most spectacular crash in the history of the New York Stock Exchange.

Serious misgivings have also been expressed regarding the prevalence of certain types of consumer credit, such as instalment credit It has been pointed out that so long as prices are stable and business can be maintained steadily at a high level, a moderate expansion of credit in anticipation of income can be effected without any serious consequences In a time of depression, however, those who have bought luxury articles on credit, whose incomes have been

[1] E. A G. Robinson, *The Structure of Competitive Industry.*

diminished through unemployment or reduced wages and profits, find themselves either unable to meet their obligations, or able to meet them only by reducing their normal purchases of other and more necessary articles.

We recognize that the system has advantages in facilitating regularity of budgeting with the weekly or monthly income, and of advancing the date upon which a purchaser can begin to enjoy the use of some article that adds to the comfort and enjoyment of himself and of his family. Instalment buying is, however, costly, since the cost of collection and supervision of the debt as well as other expenses are additions to the purchase price, and it probably leads to articles being bought with less thought for the future than would be the case if cash had to be paid for them at the time of purchase. [1]

From the standpoint of the producer and the merchant, the credit system contains latent dangers. In a time of good trade there is always a tendency for credit to be advanced in an unsystematic manner. Retail distributors, for example, allow their customers to buy goods on credit in order to make sales, because they feel that if they withhold credit, the customer will obtain it from a competitor. The average amount of credit advanced to each customer may be small, but as there will in all probability be a large number of accounts, the amount of capital involved may be disproportionately great in comparison with the total assets of the trader. Moreover, credit of this description tends to be expensive, for the work of collecting outstanding accounts is difficult. The trader is often tempted to continue to advance credit to a customer who is backward with payments for fear of giving offence leading to a transference of custom elsewhere. In consequence, the loss is increased and "good money is thrown after bad." Such overtrading on the part of retailers tends to have undesirable effects upon other sections of the chain of distribution. Wholesale dealers are compelled to grant extended terms of credit to retailers, whilst in turn they look to the manufacturer to do the same. Sooner or later, something occurs to give a shock to business confidence, with the result that there is a pressure throughout the system for the liquidation of this indebtedness, in the course of which many firms are put out of business.

[1] *Minutes of Evidence taken before the Committee on Finance and Industry* (Vol. II.) Statement of evidence submitted by the Joint Parliamentary Committee of the Co-operative Congress.

TEST PAPER 3

1. "The time element enters into all credit transactions, yet the essence of credit is confidence on the part of the creditor in the debtor's willingness and ability to pay his debt" Discuss this statement.
2. "Credit arises from the divorce of the ownership of wealth and its use" Test the truth of this statement by reference to modern economic organization
3. Show how the economic stability of a country may be threatened by (*a*) an over-extension, and (*b*) an undue curtailment of credit.
4. Distinguish between the following forms of credit. (*a*) Producer's credit; (*b*) Intermediate credit; (*c*) Consumption credit; (*d*) Public credit, (*e*) Secured and unsecured credit; (*f*) Redeemable and irredeemable credit.
5. Draw the diagram on page 65 and explain its meaning.
6. Explain the economic advantages which result from the existence of a system of credit
7. "Credit is a condition which may be expressed on the one side as the power of business men and others to borrow from capitalists, and on the other, as the confidence on the part of the investor in the person to whom he entrusts his capital" Discuss this statement.

CHAPTER IV

Bank of England and Its Functions

The word " bank " takes us back into the early history of finance In the middle of the twelfth century, when the great powers of the world were the Italian Republics of Venice and Florence, a struggle was just beginning with Austria, whose rulers were attempting to invade Italy. At this time Venice found herself in considerable financial difficulties and was in such need of funds that she was led to raise one of those compulsory loans which were subsequently known in England as *Benevolences*. It was subscribed by the forced contributions of the citizens of Venice. For the purpose of managing this public debt, a body of commissioners was instituted called the Chamber of Loans, and this body, a considerable time later, added the banking business to its original function

The word " bank " itself is said to be derived from the Italian word *banco*, meaning a bench. The earliest bankers, the Jews of Lombardy, transacted their business at benches in the market place. When a banker failed, his *banco* was broken up by the people, whence we derive our word " bankrupt "

DEVELOPMENT OF EARLY BANKING. Early banking in Florence took the form of *giro* or circle banking, where the banker issued notes against deposits of specie placed in his charge These notes passed from hand to hand, the deposit remaining untouched, until the whole circle of transactions was completed. The banker himself made no use of the money but was simply paid a fee for guarding it. The private bankers of Florence gained a powerful position in financial affairs, and the sphere of their influence was international in its scope. During the fifteenth century the financing of foreign trade had assumed sufficient importance to constitute the business of a special group of financial intermediaries, whilst, in the first half of the sixteenth century, the word " banker " was coming into general use in England to denote a moneylender engaged in international finance. Mr. R. H. Tawney, in his work *Religion and the*

Rise of Capitalism, shows the development of the financial aspect of trade in the days of the great trading companies—

A steady flow of capital was needed to finance the movement of the produce handled on the world market, such as the eastern spice crop—above all pepper, which the impecunious Portuguese Government sold in bulk, while it was still on the water, to German syndicates—copper, alum, the precious metals, and the cloth shipped by the English Merchant Adventurers The cheapening of bullion and the rise in prices swelled the profits seeking investment, the growth of an international banking system mobilized immense resources at the strategic points, and, since Antwerp was a capital of the European money market, the bill on Antwerp was the commonest form of international currency Linked to each other by the presence in each of the great financial houses of the Continent, with liquid funds pouring in from mines in Hungary and the Tyrol, trading ventures in the East, taxes wrung from Spanish peasants, speculation on the part of financiers and savings invested by the general public, Antwerp, Lyons, Frankfort, and Venice, and in the second rank, Rouen, Paris, Strasbourg, Seville, and London, had developed by the middle of the century a considerable class of financial specialists, and a financial technique identical, in all essentials, with that of the present day. They formed together the departments of an international clearing house, where bills could be readily discounted, drafts on any important city could be obtained, and the paper of merchants of almost every nationality changed hands

It is claimed that the Bank of Barcelona, established in 1401, was the first bank in the modern sense of the word. In this year, the magistrates erected a public bank for receiving the deposits of customers and for discounting bills. So far as England is concerned, even in the early years of Elizabeth's reign, the term banker was in use to denote an exchange specialist, whilst there is strong reason for believing that the banking activities of the goldsmiths was a powerful factor in the economic development of Stuart England. An investigator into the early history of banking in England says that—

The "shops" of the wealthiest of the London goldsmiths of the post-Restoration period were really important banking establishments, and in some of these the banker's trade was undoubtedly greater than that of the *aurifaber*. Interest was paid on deposits; loans were supplied, bills of exchange, tallies and various types of Treasury-Exchequer payment orders were discounted; promissory notes which circulated freely were issued; cheques were used, bullion was bought and sold; foreign coins were changed, systematic accounts were kept in special ledgers.[1]

[1] P. D. Richards, *Economic History*, January, 1928

EARLY ENGLISH BANKING. The Bank of England is one of the oldest banking institutions in the world, and although nominally it is a private undertaking, in practice it has attained to the dignity of a national institution Before 1640, it has been said that banking, in the modern sense of the word, had no existence, but events at this time clearly indicate the influence which political matters may exert upon economic institutions. The great merchants of the day had acquired the habit of depositing their bullion at the Tower, deeming this to be the safest of all places. Unfortunately they had not reckoned upon the cupidity of rulers nor the lengths to which they might be prepared to go in desperation. Charles I, being in desperate need of money, and having exhausted every other expedient, seized these deposits, which amounted to £130,000. Public opinion was sufficiently strong to make him restore what he had taken, but the cost was a loan of £40,000. But the worst effect of this ill-considered action was the loss of confidence which it engendered, and the merchants began to store their own coin.

Even with this, however, their troubles were not ended, for, with the outbreak of the Civil War, " a warlike spirit seized upon everyone, and amongst others upon the cashiers, who went off to join one or other of the opposed armies taking their masters' money with them."[1] Hence, there soon arose the custom of depositing surplus funds with the goldsmiths, whose reputation for honesty was of the highest. Thus there arose a class of people who transacted the first banking business in England. They speedily amassed considerable funds, which came into their hands at a low rate of interest, and in some cases at no interest at all, and this they lent out at high rates. This class of business was naturally a remunerative one, and we soon find the goldsmiths trying to stimulate it by offering to pay an attractive rate of interest on deposits and allow withdrawal without notice. Although, as we have stated, the goldsmiths received a full measure of public confidence, their actions did not at all times justify this trust. Much of the money deposited with them was lost, partly through unwise loans on their part, and partly as a result of the defalcations of their servants. In other words, banking in the modern sense was still to come, for they lacked one of the greatest qualities of their successors—stability.

[1] *History of the Bank of England*, Andreades.

After the Restoration the part played by the goldsmith-bankers became still more prominent. Charles II, like his father, was continually in need of money, and was in the habit of obtaining loans against the security of the yield of certain taxes. This custom soon drew upon the goldsmiths all the unpopularity which is the lot of tax farmers, and current ideas of their extortions are not altogether devoid of truth. In 1667 occurred the first "run on the banks," when a hostile Dutch fleet entered the Thames and threatened London. Public confidence in the Government was badly shaken, and this led to a heavy demand to withdraw deposits in the hands of the goldsmiths. These misgivings were calmed by a Royal Proclamation, but in 1672 the goldsmiths received yet another blow when the Exchequer stopped payment for twelve months. In spite of assurances from the King that they would be paid, nothing was done in the matter until 1677, when a payment of interest at the rate of 6 per cent per annum was granted. This ceased in 1683 and was never resumed. It has been estimated that the early bankers lost about £3,000,000 in this transaction.

RISE OF THE BANK OF ENGLAND. The Bank of England was founded in 1694 as a private institution, and was based upon a scheme put forward by William Paterson. Briefly, the plan was to raise the sum of £1,200,000, which was to be lent to the Government in consideration of an annual interest of 8 per cent. Those who subscribed were to form a corporation under the title of the Governor and Company of the Bank of England, with the right to issue notes up to the extent of the subscribed capital. Despite violent opposition the foundation of the Bank was authorized. The original charter was granted for a period of ten years, when it could be cancelled by the Government after giving one year's notice. The peculiar dual nature of the Bank has been preserved up to this day. On the one hand, it is an ordinary joint-stock company working for profit, and, on the other, it is an institution which, equipped with special privileges, exercises functions which in other countries are the prerogative of the state.

The Bank received its charter under the authority of the Tonnage Act passed in May, 1694. It was feared in some quarters that such a powerful institution as was here proposed to be formed would attract all the available funds in the country and would, in

consequence, be able to impose onerous terms on borrowers. There was also opposition from numerous vested interests such as those of the goldsmiths and moneylenders, who were apprehensive as to their own profits in competition with a powerful corporation. Last, but by no means least, the promoters of the scheme had to contend with the jealousy of those who had schemes of their own and who saw that there would be no place for them if this project were successful. The powers of the Bank were limited by two important clauses. In order to prevent any danger of the King ignoring Parliament and raising money by direct borrowing from the Bank, the institution was prohibited from lending money to the Crown without Parliamentary consent. A second prohibition was that the Bank was to be debarred for all time from using any of its funds for dealing in merchandise or wares of any description.

The renewal or further extension of their priviliges in the course of the eighteenth century was always associated with further advances of money, so that, in 1708, when the right of issuing notes was extended, it was stipulated that no other company of more than six members should be allowed to issue notes. Thus, the Act of 1708 provided that—

> From 29th September, 1708, during the continuance of the Governor and Company of the Bank of England, it shall not be lawful for any body politic or corporation whatsoever erected or to be erected other than the said Governor and Company of the Bank of England, or for other persons whatsoever united or to be united in covenant or partnership, exceeding the number of six persons, in that part of Great Britain called England, to borrow, owe, or take up any sum or sums of money on their bills or notes, payable at demand, or at any less time than six months from the borrowing thereof.

It has been said that there was nothing in this statute to prevent the foundation of a joint-stock bank having more than six members for the purpose of carrying on deposit banking. This clause was merely inserted, however, to supplement one contained in an Act of 1697 stating that no other banking corporation would be recognized during the continuance of the Bank of England. The two clauses were combined in another Act passed in 1742, evidently with the full intention of conferring a monopoly of joint-stock banking upon the Bank of England, and there can be little doubt that any attempt to found a banking concern with more than six

members would have been suppressed even though it was going to confine its business to deposit banking

The Bank has exercised almost exclusively the administration of the National Debt since 1752. In this year an Act was passed consolidating various loans into one fund which now became known as "Consols." The entire management of these funds was entrusted to the Bank which, from this time onward, administered the whole national debt with the exception of the South Sea Company Stock

In 1789 the French Revolution broke out, though the economic condition of this Country was not immediately affected By 1792, however, there was a state of growing apprehension regarding the position on the continent combined with a very unstable credit position in this country due to the increase in the number of country banks which had over-extended credit. A sudden declaration of war by France in the following year precipitated a crisis which the Bank contrived to stave off with the assistance of the Government. The country was now faced with the task of financing a great European war and the Government, of necessity, had to throw much of the burden upon the Bank of England Although the Bank was precluded from lending money to the Government without formal consent of Parliament, the custom had grown up during the War of American Independence of making advances against such Treasury Bills as were payable at the Bank pending the receipt of orders instructing such advances to be set off against the accounts to which they belonged. The Bank directors were doubtful as to their legal position and asked that the practice be stopped. The Government found it impossible to comply with this request, but after further pressure an Act of indemnity was passed but without prescribing any limitation of the amount to be so borrowed. The Bank itself fixed the limit of advances on Treasury Bills at £500,000, but by 1794 this amount has been exceeded considerably. The next three years saw a constant pressure on the Bank for further advances which were usually made after protest and grave warnings. The Bank was reluctant to refuse advances, partly for patriotic reasons, and partly because of the shock to confidence which such refusal would inflict.

By 1797 the cash reserve of the Bank had fallen so low as to cause great uneasiness on the part of the directors. There were fears

of a French invasion and, when a landing of troops in Wales from a French frigate was reported, Pitt realized that this would cause a run on the Bank and caused an Order in Council to be issued to the directors prohibiting them from making payments in cash. The general dismay on the part of the public was allayed somewhat by an announcement on the part of many leading merchants that they would accept bank-notes in payment of any sums due to them. The period of restriction continued until 1821 when, at the request of the directors, an Act was passed allowing cash payments to be resumed. The resumption of cash payments was followed by a rapid contraction of credit, and the resulting deflation caused a fall in prices of some 40 per cent. But the depression soon passed away and increasing confidence gave rise to speculation, particularly in connexion with the trade with the new republics of South America. The small private banks again inflated credit by an over-issue of notes, and the collapse which followed in 1825, although not unexpected, was none the less disastrous

In consequence of this collapse, which involved a large number of the country banks and even extended to London, the Government took the view that the existing state of the law was such as to encourage the formation of unsound banking houses Lord Liverpool, the Prime Minister, in criticizing the Act of 1709, pointed out that "Any small tradesman, a cheesemonger, a butcher, or a shoemaker, may open a country bank, but a set of persons with a fortune sufficient to carry on the concern with security are not permitted to do so." It was considered that the monopoly of the Bank of England was out-of-date, and that a sound banking system could be established only by the opening of branches of the Bank of England all over the country, or by revoking the restriction on the formation of banks with more than six partners in order to permit the formation of substantial banking houses. Somewhat reluctantly the Bank agreed to the latter course, and in 1826 an Act was passed permitting the formation of partnerhips of more than six persons operating beyond a radius of sixty-five miles from London. At the same time, the Bank itself was empowered to appoint agents in any part of England on condition that the notes issued by them should be payable locally as well as in London. In the same year a further measure was passed prohibiting the issue of notes payable

to bearer on demand for denominations of less than £5, as an attempt to check the irresponsible attitude of small banks in the issue of notes.

In 1833 the Bank Charter came up for renewal once more. Ever since the passing of the Act of 1826 it had been a debatable point of law whether or not the Act prohibited joint-stock banks from opening offices in London for business other than the issue of notes. There were many, notably Thomas Joplin, who considered that a strict interpretation of the law would allow joint-stock banks conducting a deposit business and not issuing notes, to carry on business in London, whilst the law officers of the Crown were of a similar opinion In order to set all doubts at rest, a clause was introduced into the Bank Charter Act, 1833, permittng the establishment of banks with any number of partners in London and within sixty-five miles provided that such banks did not " borrow, owe, or take up in England any sum or sums of money on their Bills and notes payable on demand, or at any less time than six months from the borrowing thereof." The notes issued by the Bank of England were declared to be legal tender for all amounts above £5 except at the Bank itself, so long as the Bank should maintain their convertibility into gold.

The difficulties experienced by the Bank in 1838–9, owing to its lack of a definite discount policy, led to a heated controversy concerning the functions of a central bank, and finally culminated in the famous Bank Charter Act of 1844. This new Act was in accordance with the theories of the Currency School, under the leadership of Lord Overstone; the school had gained the ear of the Prime Minister, and saw the source of the financial troubles of the country in the unlimited note issue of the Bank of England and of the private banks. They expected to be able to eliminate this by the regulation of the note issue in such a manner that the notes were always backed by bullion. Since this school regarded only gold and bank-notes as currency, they hoped to achieve their purpose by prohibiting the banks from issuing more than their average for the last decade unless they were covered by gold.

It is particularly noteworthy that in the heat of the controversy, which lasted right into the 'seventies, the fact was completely overlooked that the note issue, which formerly had constituted

the most important part of the banking business, was tending to become relegated to the background by the expansion of the deposit business. The result was that the holder of a bank-note was secured in every conceivable way by law, but that, on the other hand, the safety of the deposits entrusted to the banks was left entirely to their discretion.

The Bank Charter Act of 1844 accepted the broad principles of the Currency School of thought without conforming completely to them. A strict interpretation of these principles would have led to the issue of bullion certificates completely covered by gold, whereas the Act provided for a fiduciary issue of £14 millions covered by securities only. Any notes issued over and above this amount had to be covered by gold. The Bank was divided into two separate departments, one for banking business and the other for the issue of notes, whilst provision was made for the publication of a weekly return showing the position of the two departments. The question of the right of note issue was also dealt with. Banks which possessed rights of issue could not increase their circulation, and the right was lost altogether if, by amalgamation or otherwise, the number of partners in such firms increased to more than six. In the case of an issue of notes which was discontinued for any cause, the Bank of England might increase its own fiduciary issue by not more than two-thirds of the lapsed issue. The Bank Charter Act of 1844 had to be suspended three times during the first twenty-two years of its operation owing to financial crises, but afterward, until the outbreak of war in 1914, its operation continued without interruption. During the War, the Currency and Bank Notes Act of 1914 authorized the issue of Bank of England notes in excess of the limits fixed by law to such an extent as might be authorized by the Treasury. The important change in practice was, however, that during the War and for ten years afterwards currency notes for £1 and 10s. were issued by the Treasury, the amount and manner of the issues being entirely within the discretion of that department. The next great change occurred with the enactment of the Currency and Bank Notes Act, 1928, the details of which are discussed below.

FUNCTIONS OF THE BANK OF ENGLAND. By virtue of its position as a member of that class of financial institutions known as Central Banks, a number of functions devolve upon the Bank of England.

The precise nature of these duties is still a matter of dispute amongst monetary theorists, for it is impossible to put forward a conception of central banking which will be suitable to all countries for all time. A central bank, like every other type of economic institution, is susceptible to change in an ever-changing economic environment One conception of its work is always true—it is an organization which is charged with the safeguarding of public interests rather than of earning dividends It is responsible for the stability of national credit, a matter of supreme importance in a modern community. Experience has shown that there is an absolute interdependence between the public finances and the monetary system of a country, whilst both are inseparably connected with general economic prosperity. In England, where the Bank is a private institution and the entire property of its shareholders, its duty to the public is none the less recognized very clearly.

In this connection, as was pointed out by a witness before the Committee on Finance and Industry, a central bank should not be under the necessity, whenever it has to undertake operations, of considering whether they are to the immediate interest of its own stockholders. It must not be under the necessity of having to assure itself of earning profits from every operation which it may undertake. Indeed, it may often be compelled to go to the other extreme and actually sacrifice assets of a profit-earning character or undertake transactions which it knows can result only in loss. It must, therefore, be able to hold such a position as to be free from the anxiety and care of having to order its operations from the point of view of earning profits. For this reason it is usually agreed that a central bank should not pay interest on deposits.

One of the principal functions associated with the idea of a central bank is the issuing and the regulation of the currency of a country. In the issue of metallic currency, the State has in all cases retained the sole right of issue, but in the case of paper currency, this function has, in the majority of instances, been delegated to the central financial institution of the community. Note issue has now become an official function upon which the Government seeks to exercise a measure of control in the public interest, with a view to the maintenance of general monetary stability The Bank of England is a private institution and, in theory at all events,

THE BANK OF ENGLAND AND ITS FUNCTIONS

In the capacity of a Central Bank the Bank of England performs

- Monetary Regulation
  - (1) Issues and maintains the paper currency.
  - (2) Controls the fiduciary issue (under the authority of the Treasury).
  - (3) Maintains the gold reserve.
- Banking Functions
  - (1) Keeps the banking accounts of the Government.
  - (2) Advances short-term loans to the Government.
  - (3) Holds cash reserves of the commercial banks
  - (4) Administers the national debt.
- Credit Control
  - (1) Determines interest rates (through the Bank Rate).
  - (2) Conducts its "open market" policy (purchase and sale of securities).
- Co-operation with Central Banks.
  - (1) Holds accounts of foreign central banks.
  - (2) Formulates schemes of financial reconstruction.
  - (3) Exchanges statistical and other information
  - (4) Co-ordinates monetary policy.

The most important function of the Bank of England, as in the case of any other central bank, is that of maintaining, in the general interest of the community, the stability of the national monetary unit The other duties which it performs are subordinated to this principal function and are directed towards the same end. Thus, in the performance of its banking functions it exerts its influence to prevent the financial operations of the Government and the commercial banks from threatening monetary stability, whilst its attempts at credit control are directed towards the same end Finally, it co-operates with other central banks in order to attempt to facilitate the working of an international monetary and banking system

independent of the Government. It has been hoped by many that, by placing a note issue in the hands of such an institution on definite terms, an automatic regulation of the currency will be secured and arbitrary Government interference will be obviated. Yet, as Mr Hawtrey remarks in *Trade and Credit*—

> As a safeguard against inflation, no reliance can be placed upon the independence of a central bank Whatever the law may say, the central bank will lend to the Government in an emergency. The only defence against inflation is to be found in the wisdom of the financial world in general, and of Finance Ministers and central banks in particular.

The issue of paper currency then, although best entrusted to the central bank rather than to a large number of irresponsible banking units, cannot be said to be infallible when placed in such hands. It is always liable to break down in times of economic stress and to expose the community to the evils of inflation.

Hence, in the performance of this duty of note issue, the central bank must observe a number of principles if financial stability is to be secured. The value of the notes issued must obviously be maintained at par with the standard money if they are not to disrupt the working of the entire system. In order to ensure this parity of value the Government will usually enact that certain reserves of the standard metal shall be held against the note issue, the ratio of this reserve to issues varying according to the caution of the Government in question. A second principle which must be kept in view by a bank of issue is that the volume of notes in circulation must possess elasticity to expand or to contract according to the needs of business. Considerable controversy has arisen in recent years over this question, and the policy and powers exercised by the Bank of England have not escaped criticism. There are many who maintain that the policy of caution on the part of the Bank has caused considerable injury to industry and trade, but this question will be considered more fully below as part of the wider problem of the control of credit.

A second obligation of a central bank is to create reserve credit where needed. The variations in the demand for bank credit from time to time can be met normally from the margin of reserve of the individual bank, but large increases in demand for credit necessitate

a measure of outside aid. The maintenance of reserves by each individual bank sufficient to meet all contingencies would be a wasteful process, since such variations in the demand for credit over the whole country will rarely be uniform or in the same direction, so that the problem of meeting them resolves itself into one of a rapid compensatory shifting of credit from the places where demand may be relaxing to places where it is strengthening. The process adopted by a bank desirous of strengthening its position is that of re-discounting bills, which process furnishes the money market with a means of liquefying or releasing capital which would otherwise be temporarily locked up in discounts. When application is made to the central bank, outside capital is introduced, which unlocks the normal discount funds of the money market It tends to bring about an economical utilization of funds by preventing their excessive accumulation at one point and scarcity at another. A bank may proceed to strengthen its position in this way either directly or indirectly, according to the custom of the money market In this country, for example, it is contrary to custom for the joint-stock banks to re-discount bills with the Bank of England, and when they desire to strengthen their cash position they do so by calling in loans—a process which compels the market to apply to the Bank of England for credit. It is thus through an increased re-discounting of bills for bill brokers and discount houses that the market is able to obtain additional credit from the Bank of England. In the United States, on the contrary, the same result is obtained by the commercial bank borrowing from the Reserve Banks by the re-discounting of eligible paper.

Closely associated with the foregoing is the relation of the central bank to the ordinary commercial banks when it acts as the "Bankers' Bank." Although there is no legal obligation upon the ordinary joint-stock banks to maintain their reserves at the Bank of England, custom and convention prescribe that this shall be done, and the majority of the banks maintain a more or less uniform ratio of from 10 to 12 per cent of cash reserves against deposit liabilities. This co-operation between the principal banks is of the greatest importance in view of the obligation on the central bank to create reserve credit on the lines mentioned above, for, unless other banks maintain a reasonable reserve with the central bank, the latter institution

may be compelled to restrict credit unduly when it is most needed. Furthermore, any departure from this conventional policy of holding reserves with the Bank of England would place the joint-stock banks in a position to expand credit in a way that might jeopardize the powers of control of the Bank. This difficulty may be overcome by the State compelling the ordinary banks to maintain a specified proportion of their reserves on deposit with the central bank. In the words of Professor Gregory—

> Any group of commercial banks can be made subservient to a central bank by means of legislation forcing the banks to keep such a large volume of reserve cash at the central bank as to require the assistance of the latter if the normal volume of credit is to be sustained. Thus the function of acting as "Bankers' Bank" appears in a new light, it may, under given conditions, be a means, not so much of affording emergency assistance to the commercial banks or of economizing gold, but of conserving to the central bank at all times a power of intervening on the market. It must be confessed, however, that in the United States, for example, the tendency of legislation has been rather to weaken than to strengthen the degree to which the commercial banks are subordinated to the central bank in the manner indicated. Further, if the increase in the reserve required to be carried at the central bank is large in relation to the resources of the commercial banks, it may be politically impossible to pass legislation giving the central bank such means of control.[1]

Another highly important service which it is essential should be performed by a central bank is that of conducting the banking business of the Government. The Government collects, year by year, vast sums of money from the community by way of taxes, these sums being again distributed in payment for services rendered to the State and in payment of interest on the national debt and of sums due to holders of maturing obligations of the State. Yet the incidence of these receipts and payments is very unevenly distributed. Certain revenues are always being received, such as those from Customs and Excise, but others are received by the Government only at certain periods of the year, a notable example being the collection of income tax and sur-tax which occurs during the early months of the year. In contrast to these irregular receipts, the State has obligations which are falling due practically day by day, so that some effective method has to be devised of dealing with them.

[1] "The Theory of Central Banking" in *Lloyds Bank Monthly Review*, April, 1930.

Let us suppose that the Government has to distribute about £50 millions in War Loan interest on a given day. Now, if the Government were to make provision for this payment by gradually drawing this sum from the public and keeping it lying idle until the day when it is required, there is likely to be a harmful contraction of credit while the process is going on. But on the day when the interest payment is made, the sudden distribution of £50 millions will now create an enormous expansion in the volume of credit with disastrous price movements and business instability. If, therefore, the central bank is to be entrusted with the task of maintaining monetary stability, the duty of making such distributions of funds on Government account must also be vested in it. If this is not done, the violent oscillations in the volume of credit will inevitably create great disturbances in the value of money from day to day. If, however, the whole of the arrangements are left in the hands of the central bank, it can so lay its plans that the Government has the funds which it needs and, at the same time, when these funds have been distributed, they may be reabsorbed in an orderly and gradual manner without causing undue disturbance.

Over and above these positive functions which are held to constitute the duties of a central bank, there are also certain limitations which are necessarily imposed upon it. In the first place, it must maintain its assets in the most liquid form possible. It has to provide that the ordinary trading banks of the country shall have sufficient credit available to form the basis of the credit which they themselves find it necessary to create to meet the varying demands of their customers. Unless, therefore, the central bank maintains its assets in a liquid form, it can never be certain that it will always be able to perform this task without causing unnecessary disturbance. A second rule which should be observed by a central bank is that of refraining from participating in the ordinary commercial banking business of the country. As we have seen, the central bank acts as custodian of a considerable part of the reserves of the ordinary commercial bankers, so that it is only fair that it should refrain from employing these funds to compete with its own customers for business. An even more powerful reason for the observance of this rule is to be found in the fact that participation in commercial banking may impair the efficiency of the central

bank for the performance of its own duties In times of crisis, the ordinary banks are accustomed to look to the central bank for assistance, but if the central bank is engaging in the same class of business as themselves, it is likely to be involved in the same difficulties.

ORGANIZATION OF THE BANK OF ENGLAND.[1] For the purposes of organization the Bank is divided into two main departments, although there are other subsidiary departments. The first of these performs all the banking functions of the institution, including the issue of notes, whilst the other is concerned with all the operations incidental to the management of the public debt, such as the payment of interest and the registration of transfers. This division is quite distinct from that laid down in the Act of 1844, separating the Banking from the Issue Department.

The charter under which the Bank is constituted leaves the institution with great freedom of action. Unlike other central banks its operations are governed principally by a code of unwritten laws which have been evolved in the light of experience. A supplemental charter was granted in 1892, but it deals only with matters of internal routine. The Court of Directors, which is the body responsible for the administrative work of the Bank, meets every week. In order to constitute a court, it is required by the by-laws that there shall be present the governor, or the deputy-governor, and thirteen out of the twenty-six directors. The Court also appoints various committees of its members to deal with different sections of the Bank's work. There is what is known as the Committee of Treasury, which might be described as a kind of Inner Cabinet of the Bank. It is composed of nine members, the governor and deputy-governor are ex-officio members, whilst the remainder are elected by secret ballot of the whole Court. It functions as a special body with whom the governors can consult regarding all the more important business of the Bank—such as the fixing of the Bank rate. There are also other committees dealing with such matters as staff, buildings, and internal organization.

With regard to the staff of the Bank, the senior official is termed the Comptroller, who acts as a connecting link between the Court

[1] The bulk of the matter in this section is based upon the evidence given by Sir Ernest Harvey before the Committee on Finance and Industry.

and the clerical and official staff He relieves the governors of much of the work of internal administration, and he attends all meetings of committees so that an official view is always available on any subject that may come up for discussion In addition, there are other officials who act in an advisory capacity in connection with special branches of the Bank's business, many of which are of recent development, such as those concerned with the rationalization of industry and the cultivation of relationships with foreign central banks. Indeed, in connection with the latter function, a department has been formed to deal with the work, and members of the staff are in the habit of travelling at frequent intervals to interview the governors and higher officials of foreign central banks, whilst, in turn, visits are received from them.

The Bank has an office which collects and prepares statistics regarding industry and commerce, showing trends of the trade of both this and foreign countries. It receives information from foreign sources, collates it, and compares it with our own. Formerly, this information was circulated only to foreign and dominion central banks, but in consequence of a recommendation of the Macmillan Committee on Finance and Industry, the Bank commenced in 1932 the publication of a statistical summary Most of the statistics included in the bulletin are obtainable from other sources, but the figures are supplemented by a series of charts.

There is a secretary's department, which performs work of much the same nature as that of a similar department in any other business. Then there is an audit department, which is continually engaged in conducting audits of various portions of the Bank's work. It is independent of all Bank officials and is the direct servant of the governor and directors It reports to them direct regarding the position which is revealed by its investigations. The chief cashier is another important official who is in charge of the department entrusted with the task of carrying out all its responsible banking duties, other than those deputed to special sections, such as the duties of the accountant's department which is concerned with the management of stocks. There is also a big printing works, though this is not situated on the Bank premises. It is primarily maintained for the production of all the Government dividend warrants and bank-notes. This department had its origin in the eighteenth

century, for, in 1783, the directors of the Bank became very concerned with regard to the haphazard methods of business in many departments and set up a special committee of inquiry. Various irregularities had been detected, including frauds on the Bank by members of the staff and large numbers of cleverly forged notes. This committee put forward a suggestion that notes should be printed in the Bank, but this was not done until 1794 when accommodation was first provided. The two engravers and printers appointed to supervise the work were not sworn servants of the Bank and they employed their own men, the directors having no voice in their engagement and discharge. Terry and Cole, the engravers, were in fact a private firm carrying on their business within the Bank, for they found their own materials, except the printing presses and copper for the plates, and were paid by the plate for engraving and by the ream for printing. This system proved to be unsatisfactory and successive modifications were introduced until, in 1810, the storekeeper's and printing offices were established, and the persons employed in these offices were elected into the service of the Bank in a similar manner to those chosen for the clerical staff

Some idea of the size of the Bank and the extent to which it has grown as a result of the additional work which has been imposed on it since the War, may be gained from the size of the staff, which in pre-War days numbered about 1,000, but now comprises some 3,800 persons. The magnitude of the work which the institution has to undertake in connection with the administration of the National Debt, for example, may be gathered by the fact that there are on the books of the Bank upwards of 3,000,000 separate stock accounts, quite apart from the very large holdings of bearer securities. During the course of a year, about 1,000,000 transfers have to be recorded; about 5,000,000 dividend warrants and an equal number of coupons are paid, whilst about 650,000,000 notes are issued.

With regard to the directors themselves, they are elected to the Court as men of first-class credit in the City of London, who are associated with trade of some kind, whether home or foreign. They are not necessarily holders of Bank stock at the time of selection, though they must become such before they can join the Court.

They are selected as men who can bring to the Court first-hand information as to what is occurring in various spheres of business. There has never been any idea that members shall be chosen strictly as representatives of a particular industry. If they are informed regarding the affairs of a given industry it is all to the advantage of the Bank, but they do not come as recognized representatives. The appointment of directors as representatives of particular interests tends to tie them to those interests and makes them view every question submitted to them with a bias.

REGULATION OF CREDIT. We have already referred to the facilities which the Bank of England provides for the joint-stock banks in supplying additional credit when needed. This naturally involves the central bank in another duty of equal importance, namely, that of maintaining a sound credit situation and avoiding unnecessary disturbance of the money market. At certain times of the year, abnormally large financial transactions take place, such as those in connection with interest payments on national loans. When the market might be disturbed by the sudden injection or withdrawal of an exceptional volume of resources, the central bank is called upon to undertake certain counter-operations to steady the movement of credit.

The Bank of England, as the holder of the ultimate cash reserves of the country, is entrusted with the function of the control of credit. It acts as a kind of reservoir for the supply of money and of credit to the business community, and the method whereby control is maintained over the flow of resources is through the medium of the discount rate. In order to become effective, the discount rate must be related in some way to the rates being charged by other banks and financial institutions. The close relation of the Bank of England to the money market places it in a position to enforce its control of credit on the other banks. If the banking institutions of the country increase the supply of credit to their customers there soon comes a time when there is an increased demand for cash for such transactions as the payment of wages and the settling of retail transactions This will come upon the banks themselves and will, in consequence, deplete their cash reserves. In order to restore these, the banks have to resort to the Bank of England in order to borrow cash, and this course, if left to work itself out unchecked, would

speedily lead to a heavy drain on the resources of the central institution. The Bank, therefore, raises the rate at which it is prepared to advance loans, thereby creating a discrepancy, against the banks, of the rate at which they can borrow and the rate at which they are lending. In such circumstances, the further extension of credit would be unprofitable, so that the rate which the banks are charging their customers—the market rate—is raised in order to lessen the gap. This immediately restricts the desire of customers for credit, since the amount which they have to pay for such accommodation is increased.

If, however, the cash resources of the joint-stock banks are ample for their needs, so that there is no need for them to resort to the Bank of England for accommodation, the mere raising of the Bank rate will probably have little effect upon the market rate. In such a case, the Bank of England has still a further weapon whereby it can enforce its will by selling securities in the market and, in consequence, diminishing the supply of cash. The banks now turn to the Bank of England once more, with the result outlined above. Under modern conditions, as we shall show later, these weapons employed by a central bank are not always effective for the achievement of its purpose The magnitude of the operations conducted by the ordinary joint-stock banks and the great magnitude of the resources which are at their disposal prevent them from being overshadowed by the Bank of England, as was the case in pre-war days. Such operations, therefore, do not always bring about the desired result immediately, although in a country such as Great Britain, with highly-organized financial institutions, it is generally recognized that the whole banking system should conform to the requirements of the central bank, since all action taken is for the mutual benefit of the system as a whole.

Summing up the argument which has been so far put forward, we may say that the Bank has to perform the following tasks in regard to the regulation of credit—

1. It is the business of the Bank to safeguard the basis of credit by checking undue exports of gold and expansion of loans. Raising the Bank rate will normally turn the tide of gold back to the Bank and will also check unnecessary borrowing.

2. The Bank rate is an emergency rate and should be higher than

the prevailing market rate for the same class of paper. The Bank rate does not become effective unless there is a stringency in the money market. The higher or penalty rate is necessary to discourage undue borrowing.

3 It is the Bank's policy to grant to any borrowers who are in the emergency compelled to have resort to it for funds all the accommodation to which they are entitled.

Closely associated with the control of credit is the stabilization of the general level of prices. We have already studied the economic effects of fluctuations of the price level and, of recent years, the extent to which a central bank can, or ought to, prevent or minimize such fluctuations has become a question of considerable importance. The case for preventing these violent fluctuations which have occurred in recent years is a strong one, and it is only natural that, as prices depend in part upon the supply of money and credit, people should turn to the central bank, which is responsible for the regulation of these, to provide a solution Yet, when the question is subjected to closer examination, it reveals unexpected difficulties which have given rise to considerable controversy. In the view of Professor Cassel, a central bank should, by a suitable regulation of the supply of the means of payment, be able to stabilize the general level of commodity prices. As a measure of this stability he would employ the general level of wholesale prices for—

> Fairly reliable indices of this level are already published in a number of countries. Of course, there is always some arbitrariness in choosing such an index number as a measure of the purchasing power of gold, but this is a matter of quite subordinate importance. If the world really succeeded in stabilizing the value of gold and thereby the purchasing power of every gold standard unit so as to keep invariable any of the recognized English or American index numbers for wholesale prices, the world would possess a monetary system so infinitely superior to anything it has ever seen before that it could safely regard this problem as solved and proceed to develop its economic forces on the solid monetary foundation thus laid [1]

This view has been criticized by Professor T. E. Gregory, who casts serious doubts upon the powers of the central bank to achieve any such control of credit by the employment of the weapons at its disposal. Neither by the manipulation of the discount rate nor by the purchase and sale of securities can it be absolutely certain

[1] "The Functions of Central Banks," in *Lloyds Bank Monthly Review.*

that the money market will respond in the desired way. There is a time lag between the adoption of a particular policy by the central bank and its practical fruition, and this lag is of unpredictable duration. Professor Gregory agrees that, assuming the desirability of some stabilizing policy, the stabilization of wholesale prices offers as effective a test as any, but goes on to point out certain limitations In the first place, the technical difficulties in the construction of a satisfactory index number are very considerable. We may instance the diversity of opinion which exists as to the most suitable selection of commodities to be included therein, as well as the relative weights to be assigned to each, as showing some of the actual difficulties which arise in practice. Furthermore, it is significant that when a number of indices are compared, emanating from sources of equal authority, the position which they indicate is far from being the same in each case. Yet, even if a satisfactory index can be evolved, it can only represent an average of all prices, so that stability of the wholesale price level will by no means ensure a stability of individual prices. Action by the central bank, based on this index, may give rise to undesirable price movements rather than restrict them.

In general, it is impossible on *a priori* grounds to say how particular prices will behave under pressure. Articles which remain steady in price whilst others were rising, will now fall; whilst articles which were already falling, will fall still more. Articles, the supply of which cannot be altered rapidly, or the demand for which does not respond easily to a fall in price, will suffer in comparison with articles the supply of which alters rapidly as the price falls, or the demand for which increases rapidly as the price declines. An area dependent on such an article may, therefore, be hit badly on grounds of policy initiated because of a general situation with which it may not in the least be concerned [1]

The greatest hope for securing a greater stability in the general level of prices than has hitherto been obtained lies in the education of public opinion bringing about a greater measure of co-operation and conformity with the policy adopted by the central banking institution, rather than by the employment of any machinery by the central bank itself to enforce its requirements.

Currency and Bank Notes Act, 1928. The historic change made in the regulation of British paper money by the Currency and Bank Notes Act, 1928, has again focused attention upon the intricate

[1] "The Theory of Central Banking," in *Lloyds Bank Monthly Review*

problems of currency regulation. But it is important to note that this outstanding legislative measure not only initiated a new phase in the history of British currency, but also brought to an end a remarkable financial period which commenced in 1914, when Treasury Notes were first issued through the agency of the Bank of England for £1 and 10s. The British Treasury was the sole controlling authority which decided the amount of the metallic backing and the number of notes to be put into circulation. During this period of fourteen years, the Bank of England issued notes in denominations ranging from £5 to £100, and for part of this period other British banks possessing the right of note issue, under the Bank Charter Act of 1844, issued their own paper money The last of these issuing banks was that of Fox, Fowler & Co., Somerset, which ceased to enjoy this right in 1921 upon its absorption by Lloyds Bank.

In addition, certain Scottish and Irish banks continued to issue their own notes between 1914 and 1928, and these banks still possess note-issuing powers. Recently, however, upon attainment of a Dominion status, the Irish Free State has, under a Currency Act of its own, commenced to issue its own coins and paper money. Thus, British paper money includes to-day three distinct classes—

1. Paper money issued in England under the Currency and Bank Notes Act of 1928, which is legal tender in England, Wales, Scotland, and Northern Ireland.
2. Paper money issued by certain Scottish banks.
3. Paper money issued by certain Northern Irish banks.

The second and third classes are not legal tender in England and Wales, nor is the independent paper currency of the Irish Free State, which is regulated by the Dail

Prior to the passing of the Currency and Bank Notes Act of 1928, the Bank of England was allowed to issue notes up to a total of £19,750,000 not backed by gold or silver. This was the Bank's maximum fiduciary issue, and all bank-notes issued in excess of this sum had to be fully backed by gold or gold together with an amount of silver up to one-fourth part of the gold coin and bullion held by the Bank. The 1844 Act aimed particularly at ensuring the absolute convertibility of note issues in this country, and at so regulating the paper currency that inflation would be prevented.

At the time of framing the Act, experience suggested that under no circumstances was the existing circulation of Bank of England notes to fall below a total of £14,000,000. Such an amount, under the Act, might be covered by Government securities, and this became the basis of the fiduciary issue Of this security, £11,015,000 is debt due to the Bank from the Government, whilst the balance is made up of other securities. Yet, whilst securing convertibility, the operation of the 1844 Act was, during the whole period of its currency, the object of criticism. It was said that the fiduciary issue was too small, that the provisions of the Act were ineffectual in preventing the recurrence of financial crises, and that it made no provision for the issue of additional notes in response to temporary increases in the demand for money.

In view of the crisis which arose upon the outbreak of War in 1914, it was considered necessary, not merely to authorize the suspension of the Act, but also to empower the Treasury to issue currency notes. The credits created by the Bank of England in favour of its depositors under the arrangements by which the Bank undertook to discount approved bills of exchange, and other measures taken at the same time for the protection of credit, caused a large increase in the deposits of the Bank. Further, the need of the Government for funds wherewith to finance the War in excess of the amounts raised by taxation and by loans from the public, made necessary the creation of credits in its favour by the Bank of England. The balances created by these operations passing to the joint-stock banks by means of payments to contractors and others caused in turn a great growth in their deposits. This brought about a corresponding demand for legal tender currency which necessitated continually increasing issues of currency notes. The Cunliffe Committee on Currency and Foreign Exchanges, which was appointed in 1918, to investigate the whole position and make recommendations upon future policy, advocated cautious deflation until a level of note issues was reached at which a central gold reserve of £150,000,000 could be maintained. When the fiduciary portion of the issue had been reduced to the amount which experience showed to be consistent with the maintenance of such a reserve in the Issue Department of the Bank, it was recommended that the outstanding currency notes should be retired, and Bank of England notes of low denomination

substituted, the Bank of England fiduciary issue being simultaneously increased by an amount equal to the then issue of currency notes covered by Government securities.

The Currency and Bank Notes Act of 1928 abolished the dual control of the nation's money, and responsibility for the initiation of any change in monetary policy now rests with the Bank of England. Under Section 1 (1) of the Act, the Bank of England may issue bank-notes for £1 and 10s., and these are legal tender even on payment by the Bank of England itself. The Act makes an attempt to overcome the rigidity of the pre-war system by allowing, under restriction, a variation in the magnitude of the fiduciary issue. Thus, in Clause 2, Section 2, we find provisions whereby the issue may be reduced—

> The Treasury may at any time on being requested by the Bank, direct that the amount of the fiduciary note issue shall for such period as may be determined by the Treasury, after consultation with the Bank, be reduced by such amount as may be so determined.

Under Clause 8 we find provisions for the increase of the fiduciary issue by any amount recommended by the Bank. Such an increase must receive sanction by the Treasury and may not continue for a period of more than two years without ratification by Parliament. This means that if the Bank is pressed for cash, there is virtually an unlimited supply to be had for the asking. This power was first used in August, 1931, when the fiduciary issue was increased from £260 millions to £275 millions, when the Bank's gold stocks became seriously depleted on account of heavy withdrawals to the Continent.

BANK OF ENGLAND RETURN. This Return has to be issued every week by the Bank of England, and its significance is such in financial circles that it is usually termed the Barometer of the Money Market. Its form persisted unaltered from the time of the Bank Charter Act, 1844, until the provisions of the Currency and Bank Notes Act, 1928, came into force, when a modified form was introduced similar to the example given on page 105. An examination of this Return shows that it is divided up into two sections, namely, the Issue Department and the Banking Department. Dealing with the Issue Department first, we find that the first item is concerned with notes issued, divided under two headings—notes in circulation, and

BANK OF ENGLAND

Return for week ended Wednesday, . . ., 19. .

ISSUE DEPARTMENT

	£		£
Notes issued—		Government debt .	11,015,100
In circulation . .	356,217,211	Other Government securities . . .	232,950,236
In banking department	51,288,863	Other securities .	11,942,871
		Silver coin . . .	4,091,793
		Amount of fiduciary issue	260,000,000
		Gold coin and bullion .	147,506,074
	£407,506,074		£407,506,074

BANKING DEPARTMENT

	£		£
Proprietors' capital .	14,553,000	Government securities .	34,414,684
Rest . . .	3,195,124	Other securities—	
Public deposits[1] .	5,998,939	Discounts & advances £5,634,695	
Other deposits—		Securities 25,523,623	
Bankers £58,572,050			31,158,318
Other accounts 35,511,635		Notes	51,288,863
	94,083,685	Gold and silver coin .	976,440
7-day and other bills .	7,557		
	£117,838,305		£117,838,305

[1] Including Exchequer, Savings Banks, Commissioners of National Debt, and Dividend Accounts.

BANK OF ENGLAND WEEKLY RETURN The present form of Return, which is illustrated above, is based upon a form which was prescribed in the Bank Charter Act of 1844 As published at the present day it differs in one or two respects from the original form, partly as a result of the legislation which was passed in 1928, when the currency note issue came to an end and was transferred to the Issue Department of the Bank of England, and partly as a voluntary act on the part of the Bank. Notable alterations have been the division of "Other deposits" and "Other securities" to give the details shown above, and the increase in the fiduciary issue

The fiduciary issue shown in the above Return (£260,000,000) is that laid down in the Currency and Bank Notes Act, 1928. In August, 1931, the Bank received authority to increase the issue to £275,000,000 for a limited period.

notes in the Banking Department. The total given under the heading of notes in circulation includes all the notes that have passed out of the custody of the Bank of England. That is to say, it includes not only the notes that are actually in circulation amongst the ordinary members of the public, but also all the notes which are held in the tills of the joint-stock banks, as well as notes which are set aside as cover for the issues of banks in Scotland and Northern Ireland. The second figure—that of notes in the Banking Department—represents the notes which remain in the custody of the Bank and form part of the assets which the Bank is entitled to hold against its liabilities in the Banking Department.

THE ISSUE DEPARTMENT. Turning now to the assets held in the Issue Department against these notes, we find that the first item is the Government Debt, which, as we have already seen in our examination of the historical development of the Bank, includes the sum originally lent to the Government upon its foundation, together with the various additional loans which have since been made. The amount of this debt has, however, remained unchanged since 1833. This debt is a mere book entry and is represented by no documentary security. It bears a rate of interest which was fixed originally at 8 per cent, but which gradually fell until in 1914 it reached $2\frac{1}{2}$ per cent. At the present day, the rate of interest on the debt is a matter of no concern to the Bank, because in the Act of 1928 it was provided that the whole of the net profits of the Issue Department should be paid over to the Government. As a result the interest payment has become a mere book transfer.

The second item in the Return—Other Government Securities—consists of any sort of direct obligation of the British Government, in the form of long- or short-dated securities, Treasury Bills, or Ways and Means Advances. At the present time the bulk of these securities takes the form of Treasury Bills. The third item—Other Securities—consists of all kinds of securities held except silver coin. It is left to the discretion of the Bank to decide what securities it will hold, although under the Act of 1928, the Bank is required to keep the Treasury informed as to the nature of the assets held in the Issue Department and of the transactions which take place in regard to them. The item consists, at the present time, entirely of bills, partly domestic and partly foreign, the proportion fluctuating

from week to week. Again, the division of the securities items between "Other Government Securities" and "Other Securities" is left entirely to the discretion of the Bank. At the close of every half year the securities held are valued at current market prices, and if any depreciation has taken place, provision is made out of the income of the Issue Department for them to be written down. From the amount of income yielded by these securities there have to be met the expenses of printing, issuing and cancelling notes, and the general expenses of management.

The next item appearing in the Return is that of Silver Coin. When the transfer of the currency note issue to the Bank took place in 1928, the Government were the holders of a very considerable sum of silver coin as backing for the currency notes. They had accumulated this in consequence of the reduction in the circulation of the silver coinage which occurred after the War. Under the Act of 1928, authority was given to the Bank to hold a sum not exceeding £5,500,000 of silver, so that this stock accumulated by the Government could be taken over. This holding of silver is gradually being reduced as the country requires additional silver coin, and will ultimately disappear from the Return, its place being taken by securities.

It will be seen that, by adding all the items together, we arrive at the total of the fiduciary issue, namely, £260,000,000 [1] When the magnitude of this issue was determined in 1928, the following procedure was adopted. Under existing regulations, the maximum fiduciary circulation of treasury notes in any year was the legal maximum for the following year. The computation was, therefore, made as follows—

	£ Millions
The maximum for 1927 was	244 94
To which was added the Fiduciary Issue of the Bank of England	19·75
Total	264·69
From this was deducted Currency Notes circulating in the Irish Free State, which were replaced by local currency. This amounted in round figures to	6 00
Total	£258·69
This was rounded off to make	£260·00

[1] Increased in August, 1931, to £275,000,000.

The aim in adopting a fixed fiduciary issue on the lines laid down in 1928 was to alter the existing system only to the extent that experience had shown to be necessary. It was adopted in preference to giving the power of unfettered discretion to the Bank as to how much gold it should hold against note issues, and in preference to a percentage reserve system. Statutory provision was made with a view to giving greater elasticity to the fiduciary issue so that pressure upon the Bank might be met by an increase in the fiduciary issue in preference to the adoption of the extra-statutory procedure of suspending the Bank Act. But it was pointed out when the Currency and Bank Notes Act, 1928, was under discussion that the power to increase the fiduciary issue was not one which it was intended to use reluctantly and with hesitation in times of crisis, but was intended to be employed whenever the Governor of the Bank felt that the existing fiduciary issue was unduly restrictive. A number of objections have been advanced against such a system. Thus, Mr. Keynes contends that—

> In modern times the "fixed fiduciary issue" method may work fairly well, if the fiduciary issue is fixed high enough to leave the Central Bank in unfettered control of the bulk of its gold reserves In this case its provisions operate as a check only on extreme measures of expansion by the Central Bank. Otherwise it has the effect of locking up too much gold in a fashion which has lost its *raison d'être* in countries where gold coins no longer circulate.[1]

Mr. Keynes considers that the Act of 1928 fixed the amount of the fiduciary issue at too low a level so as to fetter unreasonably the discretion of the Bank. Very similar views appear to have been held by other members of the Committee on Finance and Industry. Suppose, for example, that the total of notes issued as shown by the Bank Return is £400 millions. Then, assuming a fiduciary issue of £260 millions, the balance of £140 millions must be backed by gold, and, unless there is a further inflow of gold or some relaxation of the regulations, the Bank cannot issue another note beyond the existing total of £400 millions. In other words, this total shows the maximum number of notes available for financing trade and for supporting the superstructure of bank credit. But of the total issue of £400 millions, the greater part will be already in circulation in the hands of the general public and the joint-stock banks. In fact,

[1] *A Treatise on Money* (Vol. II).

about £360 millions will probably be circulating, leaving £40 millions with the Bank as a reserve available for the financing of an expansion of trade and credit. If, in these circumstances, an expansion of trade of about 10 per cent were to take place, and assuming no increase in prices, the additional demand for notes for the payment of wages and for small retail transactions, would be roughly in the same proportion The Bank would, therefore, have to pass some £36 millions of notes into circulation, thereby reducing its own reserve to vanishing point. Regarded from this standpoint, the Bank can do little or nothing to stimulate a revival of trade, and, indeed, may find itself in a position where it has to take action opposed to a trade revival.

The Bank may find itself having to meet a foreign drain of gold, as in the summer of 1931. This, of itself, will give rise to a curtailment of the non-fiduciary portion of the note issue. Further, in order to protect the gold reserve it will be necessary to raise the Bank rate and again cause a contraction of trade and credit.[1] In consequence of the existing regulations, therefore, the Bank is practically powerless to assist trade in the short period by an expansion of credit. Moreover, despite the assertion made at the time of passing the Act of 1928 that the powers for varying the fiduciary issue were not to be regarded as emergency powers, the Bank of England would appear to be regarding them in that light. There was no attempt made to make use of them until the crisis in August, 1931, when the fiduciary issue had to be expanded to maintain the note circulation at a sufficiently high level.[2]

It has been pointed out, too, that an arrangement which was suited to conditions in 1844 does not meet present-day needs. In pre-war days, gold was held for two purposes; gold was in active circulation whilst the notes issued by the Bank were convertible

[1] See Chapter VI

[2] According to evidence given by Sir Ernest Harvey before the Committee on Finance and Industry, the Bank did open negotiations with the Treasury with a view to a possible increase in the fiduciary issue in autumn, 1929. On the 1st October the reserve had fallen to £28,000,000, and though it was not apprehended that there would be any immediate need to increase the fiduciary issue, it was known from past experience that there would be a probable net increase in the demand for currency between that date and Christmas of about £20,000,000 Informal arrangements were practically concluded under which the Bank would have made application and would have been granted the right to increase the issue, but the need never arose. Unexpected additions to the Bank's gold stocks occurred which relieved the situation.

into gold coin upon demand, so that a reserve had to be held in case of a "run on the Bank.' Over and above this, gold was required for the purpose of meeting a foreign drain. Since 1844, however, very considerable changes have taken place. The public no longer places such reliance upon bank-notes and coin as means of exchange, but has developed the habit of using cheques. Gold is no longer in free circulation, and, even when the gold standard is in normal operation, the power to purchase gold is denied to ordinary persons, since the least amount of gold that can be bought costs £1,700. There is, in fact, no gain to be derived from the purchase of gold except to a limited number of professional dealers and exporters. There is now no danger of an internal drain of gold so that the gold reserve is held for no other purpose than to meet a foreign drain.

In view of these factors, the majority of the Committee on Finance and Industry took the view that the present fiduciary issue was not sufficiently elastic. They considered that circumstances might easily arise in which it would be desirable to allow gold to be exported without affecting credit conditions in this country by causing a contraction in the note issue. The existing procedure whereby the Bank approaches the Treasury for permission to increase the fiduciary issue is usually interpreted by the business community as a sign of weakness and gives a blow to confidence which it is desired to avoid. They would allow the Bank greater discretion and would regulate the issue by—

1. Fixing a maximum total issue of notes which could not be exceeded by the Bank without special permission.

2. Fixing a minimum figure below which the gold reserve should not be allowed to fall.

Subject to these two restrictions the Committee would allow the Bank freedom to shape its own policy, according to its judgment of what was in the general interest of the whole community. Yet, as Lord Bradbury pointed out, in dissenting from the majority of the Committee, in the event of an acute crisis the new system would tend to operate in much the same way as the old one—either it would have to be suspended or sanction must be given for an increase in the note issue or a decrease in the gold reserve. Again, in the ordinary working of the system, he considered that the facts on which the

Bank would have to base its judgment would be so difficult to interpret that legitimate differences of opinion as to the wisdom of the steps taken would be likely to arise on almost every occasion. Finally, " the times at which an increase in the legal tender circulation is required are times of trade activity and rising prices—conditions which invariably go together At such times money tends to be plentiful and inflation is apt to develop unless the expansion is kept in check."

Very similar misgivings have been expressed by Mr. F. C. Goodenough.[1] He considered that under such an arrangement as that proposed by the Committee on Finance and Industry the principles of Gresham's Law would be found to be applicable Although gold would be held by the Bank of England for purposes of regulating the exchanges, and not as backing for the currency, yet should the maximum fiduciary issue be high enough to admit of inflation taking place, and should inflation actually occur, the same consequences would follow as if gold were held in support of the currency: the inflationary influences would have the effect of raising internal prices and costs of production, so that the foreign creditor would be unwilling to take payment of his debts in goods, and would require payment in gold. The gold therefore would disappear He further considered that there would be greater difficulty in rapidly adjusting the exchanges or in maintaining their stability through the influence of the Bank rate than would happen if the currency were directly linked to gold

A further criticism of the fiduciary issue established under the Act of 1928 arises on account of its connection with the distribution of profits between the Bank of England and the Treasury. As already pointed out, the profits of the Issue Department accrue to the Treasury, but their magnitude depends on the earnings of the assets which the Bank holds against the fiduciary issue. Suppose, for example, that the Bank were to ask for an increase in the fiduciary issue of £20 millions, the first effect would be to transfer this amount of notes from the Issue to the Banking Department and an equivalent amount of securities from the Banking to the Issue Department. In these circumstances, assuming interest at the rate of five per cent, this would entail a loss of profits to the Bank of

[1] In an address on " Currency " delivered to the Institute of Actuaries.

£1,000,000. It was, in consequence, argued by the Committee that even though the Bank might be entirely indifferent to a loss of this magnitude, it is not reasonable that an action, taken as a matter of public policy, should have this arbitrary and possibly embarrassing consequence.

In reply to this criticism, it was stated on behalf of the Bank that the need for such an increase in the fiduciary issue would not arise until the banking reserve of notes was already low, so that in consequence the Bank's holding of securities would have increased. As a result, the Bank would have accumulated securites which would be available for transfer. The increase in the fiduciary issue with the consequent transfer of securities would not represent a sacrifice of normal profits of the Bank, but would rather correct an abnormal increase of profits. Considering the aspect of the question, the Committee said—

> This seems to us to overlook two considerations In the first place, if the existing system were retained, it would be a mistake if the Bank were never to apply for an increase of the fiduciary issue except when it had actually lost or was about to lose gold to the full amount of the proposed increase In the second place, even if the Bank had lost an amount of gold equal to the increase in the fiduciary issue, it does not follow that it would have wholly replaced this gold by earning assets; for the loss of gold ought sometimes to be allowed to have its direct effect of curtailing credit

In the event of a precautionary increase in the fiduciary issue in anticipation of a loss of gold, it was stated that such an increase would be made for window-dressing purposes. In all probability the mere announcement that an arrangement had been made would have the necessary psychological effect, so that the increase would never actually materialize. Yet, even if the increase took place, it would not unduly injure the profits of the Bank unless the securities in the Banking Department were reduced below normal, and even then the additional notes created would probably be quickly converted into earning assets. If this did not take place, the presumption would be that the additional notes were not required and the increase would be discontinued.

Reverting now to the Bank Return, the last item in the portion relating to the Issue Department—" Gold Coin and Bullion"— represents the gold reserve which the Bank holds against any further issue of notes. The Cunliffe Committee mentioned a figure of £150

millions as being a suitable minimum gold reserve, although the Bank has no fixed figure which it considers to be adequate at all times. The sufficiency of the gold held must depend upon the changing circumstances of the moment, such as the time of the year and the immediate liabilities of the Bank. The most important point in connection with the magnitude of the gold reserve is that the lower the level at which it is fixed, the less is our power of resistance in the face of a crisis. In other words, the lower that the figure is allowed to fall, the more necessary it may be at times to take drastic measures for the curtailment of credit.

THE BANKING DEPARTMENT. The second portion of the Return concerns the Banking Department, and, taking the items in turn, their nature is as follows—

1 The Proprietors' Capital, which is divided into fully-paid stock. The Bank is an ordinary joint-stock company, the liability of its members being limited to their holdings of share capital. The stock can be held in any amount and the Bank has about 14,000 stockholders who may be either British subjects or foreigners, though the holdings of the latter are very small No member can vote unless he has held at least £500 worth of stock in his own name for six months, but no matter how much stock he holds he cannot increase his voting power. No proxy voting is allowed.

2. The Rest is a reserve of the Bank representing an accumulation of undivided profits and the balance of profit and loss account, and the normal practice is not to allow it to fall below a figure of £3,000,000. It forms part of the Bank reserve. The rate of dividend on Bank stock has, for some time past, been stabilized, but the Bank possesses perfect freedom to vary the amount at discretion.

3. Public Deposits, which represent the sum standing to the credit of the Government Departments. Among the figures contained therein are the National Exchequer Balances, Savings Bank Deposits, Deposits by the Commissioners of the National Debt, and sums held for the payment of dividends on Government and other stocks. Every such account must be authorized by the Treasury. When a dividend has to be paid on a certain date, the Bank from past experience knows the number of warrants that are likely to be presented for payment on any day, so that the full sum need not

be provided at the outset, but only such amount as is likely to be demanded from day to day.

4. Other Deposits are the deposits of the Bank's other customers, including the balances which the great joint-stock banks hold with the Bank of England. As the balances to the credit of sundry customers is fairly stable, it is possible to judge by the fluctuations in this item the amount of the disposable funds of the money market and the trend of financial affairs. In general, a high level of Other Deposits indicates a large surplus of unemployed funds, and is usually coincident with low interest and cheap money. This item is now divided under two headings, namely, Bankers' and Other Accounts. This division is not imposed upon the Bank by statute, but is a voluntary disclosure of information made with the consent of the bankers. The Bankers' accounts are all those of British banks whose main business is conducted in this country, such as the clearing banks and provincial banks, but do not include the accounts of British banks which operate mainly overseas

The subdivision—Other Accounts—includes all bankers' accounts which are not covered in the foregoing item. It includes the balances of foreign central banks, the merchant banking houses, finance houses, discount companies, and insurance and trust companies. It also includes dividend accounts of all non-government stocks, of which the Bank manages a very considerable number. In discussing the functions of a central bank, it was stated that, in general, it is undesirable for such a bank to participate in ordinary commercial business. This has been recognized by the Bank and the present tendency is to reduce business of this class. The Bank, of course, has still large current accounts for customers other than bankers, but no new business is being undertaken. Again, such concerns as insurance companies have accounts with the Bank for a special reason. They have large amounts of securities which they like to deposit with the Bank for safe keeping, so that they keep an account in order to claim this service as customers of the Bank. Even with such customers as these, ordinary banking business is not usually transacted.

5. Seven Day and Other Bills. These are chiefly Bank post bills, which are bills of exchange at seven days' sight which have to be

met by the Bank. This item, as will be seen from its magnitude, is of minor importance.

Dealing now with the assets side of the Return, we have—

1. Government Securities, which include the Bank's investments in Government Stocks and in Exchequer Bonds and Treasury Bills, in addition to its loans to the Government on "Ways and Means Advances" and "Deficiency Bills," both of which are means of borrowing resorted to by Government Departments to tide over temporary shortages pending the receipt of tax payments

2 Other Securities, indicates the other investments of the Bank in securities, such as advances to bill brokers and to its customers other than the Government. The item is divided up into two classes, the first of which is "discounts and advances." This may include Treasury Bills if these are obtained by the Bank from private clients, but if the Bank takes them up direct, then they are included under "Government Securities." The advances are made to clients upon approved security which must be of the highest class quoted upon the London Stock Exchange. No advance is made on a security where there is any outstanding liability and no advances are made against Bank stock. The second subdivision is that of "Securities," which includes any Government guaranteed stocks, any Indian, Colonial, or foreign securities, and it may include bank and commercial bills. Ordinary shares are never taken.

3. Bank-notes consist of the amount issued by the Issue Department, but not in circulation. This reserve of notes is, in effect, the measure of the maximum amount of gold which the Bank would part with in the absence of a change in the volume of notes in circulation, unless the powers of extending the fiduciary issue are used.

4. Gold and Silver Coin. This item is quite small and consists principally of silver coins. The total of this and the foregoing item as compared with the total of Public and Other Deposits and Post Bills, is generally known as "the proportion."

CO-OPERATION BETWEEN CENTRAL BANKS. Of recent years the programme of financial reconstruction and currency stabilization which has had to be undertaken by most European countries has been much assisted by the co-operation of financial institutions of the same status as the Bank of England in other countries. Each

central bank has its own particular problems, but it has become recognized that financial conditions prevailing in one country are intimately connected with those obtaining elsewhere, and that the action taken by one central bank will depend to a large extent upon what others are doing. To cite but one example, in 1929 the Bank of England was attempting to lower interest rates in response to strong protests from industrial and commercial interests. Yet at the same time the Bank of France was accepting gold taken in large quantities from England, with the result that it became necessary to raise the Bank rate in order to protect our gold reserves. This position could in all probability have been avoided had the principal financial institutions acted in co-operation with the full knowledge of each other's intentions.

Nevertheless, despite such occurrences, there has been achieved a much larger measure of co-operative action since the War than was ever possible before. This position was partly brought about by the return of certain countries to the gold standard. Co-operation on this account was certainly not prompted exclusively by considerations of pure philanthropy, for it was to the interest of the countries on a gold basis that others should follow. As is pointed out by Dr. Paul Einzig in his book *The Bank for International Settlements*—

> If there are only two free gold markets they have to stand the full burden of fluctuating demands, while if there are a number of comparatively free gold markets the burden is more easily distributed, and the principal gold markets are relieved of part of the pressure

But co-operation has taken place in respect of another aspect of the working of the gold standard, namely, in the regulation of the demand for gold on the part of the central banks. There is a natural desire on the part of these institutions to build up their gold reserve, but heavy withdrawals from the principal holders would cause embarrassment. In such circumstances there results a position on an international scale closely resembling a "run" on an ordinary bank, resulting in a loss of gold which could have been avoided. Common agreement has averted some of the worst consequences, but mere informal understandings have failed to prevent completely this scramble for gold, with its repercussions upon financial stability.

In 1930 a big step forward was made in international finance

when a new type of institution was created in the Bank for International Settlements. It has come into existence in the course of an effort to transfer reparations payments with a minimum of disturbance to the current of world business. The treaty which fixed the amount of these payments made no provision whatever for dealing with them, regardless of their effect upon the foreign exchange market The question of the economic aspect of reparations payments cannot be entered into here, but in 1929 a Committee of Reparations Experts reported upon the question and, as the most important part of their suggestions, proposed the formation of a Bank for International Settlements. The immediate purpose of the Bank was to provide the means for the performance of such banking functions as were necessary between the initial payment of the reparations annuities and the final distribution of the funds. By operation through such an organization, the methods of which conform to ordinary commercial and financial practice, the stability of international finance is not so likely to be endangered. But the Young Committee saw a wider sphere of usefulness for the institution, not in competition with already existing banks, but in a specialized field of its own—

> In the natural course of development, it is to be expected that the Bank will in time become an organization, not simply, or even predominantly, concerned with the handling of reparations, but also with furnishing to the world of international commerce and finance important facilities hitherto lacking Especially it is to be hoped that it will become an increasingly close and valuable link in the co-operation of Central Banking institutions generally—a co-operation essential to the continuing stability of the world's credit structure.[1]

The Bank for International Settlements is located at Basle, in Switzerland, and its objects, as defined in Article 3 of its Statutes, are "to promote the co-operation of central banks and to provide additional facilities for international financial operations; and to act as Trustee or Agent in regard to international financial settlements entrusted to it under agreements with the parties concerned." The Bank is so constituted as to offer the minimum amount of competition with existing institutions compatible with performing its legitimate functions. Under the terms of its statutes certain classes of business are definitely forbidden to it, such as the

[1] Report of the Committee of Experts on Reparations

issue of notes payable at sight to bearer, the acceptance business, the opening of current accounts, and the making of loans to Governments. In addition, it cannot acquire business interests in any country nor hold real property other than that actually required for its own purpose.

The work of handling reparations payments is placed in the hands of a special department, but other work in the sphere of international banking is vested in the Banking Department. The functions of this department have been stated vaguely, probably in order to allow extension when required, but the principal tasks have been enumerated by Dr. Paul Einzig in *The Bank for International Settlements*, as follows—

1. Assistance to countries wishing to restore the gold standards.
2. Assistance in the maintenance of a gold standard in case of emergency.
3. Assistance in the relief of temporary pressure.
4. Establishment of an international gold clearing system.
5. Regular collection and exchange of information upon the international monetary situation.

The same writer suggests that, in the course of time, the Bank may undertake additional work, such as the administration of all War Debt payments, the financial reconstruction of countries such as Russia, and the appointment of financial advisers to Governments and central banks.

TEST PAPER 4

1. Outline the history of the development of the Bank of England.
2. What are the essential functions of a Central Bank? Compare as to their effective discharge of these functions, and as to their methods of operation, the Bank of England and either the Bank of France or the Federal Reserve Bank of the United States.
3. State clearly the functions of the Bank of England, and the main provisions of the Bank Charter Act, 1844.
4. It is sometimes claimed that the Bank of England is a State bank. Define the position.
5. Describe as fully as you can any two events in the history of the Bank of England of great importance to commercial development.
6. What is meant by saying that the Bank of England is the Bankers' Bank? Show its relation to the joint-stock banks and describe the work of a Central Bank.
7. Give a brief account of the organization of the Bank of England. How does it differ from the other banks in the country?

8. "The Bank of England governs the money market and hence the prosperity of industry." Explain why you agree or disagree with this statement.
9. What is meant by a One Reserve System of banking? Illustrate your answer from English and American systems.
10. What is the Bank Rate? What relation exists between this rate and other rates of interest or discount?
11. What is meant by the rate of discount? Indicate the effects of changes in this rate on (*a*) the internal trade, and (*b*) the foreign trade of the country.
12. Explain what is meant by the gold reserve. How is it controlled in this country?
13. Given normal conditions, what is likely to be the effect of a rise in the Bank Rate upon—
    (*a*) The price of securities bearing a fixed rate of interest.
    (*b*) Rates of exchange with other countries.
    (*c*) Prices in the United Kingdom.

    Note the connection between the cause and effect in each case.
14. Illustrate the importance of the Ratio of Reserve to Deposits in the case of the weekly statement of the Bank of England. In what way do you regard the movement significant from the point of view of the wholesale merchant?
15. Reproduce an illustrative weekly return of the Bank of England, and explain the significance of movements, up or down, of any two principal items therein.
16. Explain how the issue of bank-notes is regulated in this country. Is there good reason for the comparatively strict control of this form of credit?
17. What influences are likely to cause a reduction in the Bank of England reserve, and what action would probably be taken to counteract them?
18. Discuss the contention that the creation of a really satisfactory money would be regulated primarily by the needs of trade, and not by any such essentially irrelevant matter as the quantity of some particular metal.
19. If all the income tax for one year could be collected by the Government in a single week, explain in detail the changes you would expect to take place in the items of the Bank Return for that week.
20. Write a short account of the functions of the Bank for International Settlements.

CHAPTER V

Joint-stock Banking

The business of banking has evolved as a result of the application of specialization in the sphere of commerce. The various activities associated with the exchange of goods, as distinct from their production, have, in the course of time, become differentiated into a number of specialized branches of commercial activity. Of these, one of the most important is that of banking and finance. Bankers are the custodians and distributors of the liquid capital which is the life-blood of our commercial and industrial activities, and upon the prudence of their administration depends the economic well-being of the nation. A considerable portion of the capital employed by the individual manufacturer is fixed in the form of machinery, plant, and buildings, but a further portion is held in a more liquid form, as, for example, in stocks of goods. When his own resources of liquid capital are insufficient to meet requirements, then it is to the banks that the manufacturer must turn. The sum total of the deposits in the hands of these institutions—amounting to, roughly, £2,000 millions in Great Britain—constitutes a central fund out of which modern business is financed. Upon the banking administration rests the responsibility of so employing this fund that its safety shall not be imperilled, whilst at the same time, industry may receive the help and encouragement which it requires. Again, in addition to the advances which they make to particular undertakings, banks and other financial institutions play an important part in assisting industry and trade as a whole by financing the movement of raw materials and the distribution of manufactured goods.

FUNCTIONS OF MODERN BANKING. Modern banking has to perform a three-fold function in the economic system. In the first place, it has to collect from the whole of the community the savings and unused purchasing power into what we might term a great reservoir. Secondly, it has to place these sums entrusted to it at the disposal of those who can make use of them, and, thirdly, it

has to provide a suitable medium of exchange to facilitate these functions. This role as a mediator of capital shows itself with particular clearness in a country like England, where nearly the whole of the available funds of the community appear in the tills and books of the banks, and where the capital subscribed by the shareholders of the bank itself plays but a small part in comparison with the borrowed funds which the bank controls in the form of deposits.

One of the main functions of a bank is to gather up idle capital, and through its mobilizing power to employ it effectively Money in bulk is always a powerful force in the credit system. Banks become effective parts in the credit system in proportion to their aggregated money accumulations, and their standing in the credit world. Their ability to lend their credit is based upon the more or less effective manner in which they have been able to assemble the otherwise non-available supplies of capital [1]

In order to increase their prestige in the eyes of the public, the joint-stock banks employ only a relatively small percentage of their registered capital in the business, whilst the remainder is not called up and will, in most cases, be called up only if the bank should go into liquidation; it is thus a guarantee fund for the security of the money entrusted to the bank. The mere enumeration of the functions of a bank is sufficient to reveal the great claims which are made upon the organization and administration of these institutions. The collection of the surplus capital which has been brought to such a high pitch of perfection in England carries with it the obligation to maintain adequate cash reserves as a secure basis for the credit system, to maintain and protect the necessary gold reserves for this purpose, measures which have to be carried out especially with a view to preserving the country's credit with other nations Closely connected with this function is the bank's duty to procure the necessary media of exchange in the form of bank-notes, cheques, and bills of exchange, which constitute the basis of the whole banking system. The most difficult and responsible function, however, is the investment of the funds placed at the disposal of the banker. He is, in effect, the trustee of the surplus balances of the public, and a policy of over-generous and indiscriminate lending, if carried sufficiently far, can only have the effect of imperilling these balances.

[1] *The Banker's Place in Commerce*, W F Spalding.

The progress of a nation and its success in the economic struggle depend largely on the way in which these problems are faced. This is especially true in regard to England, not only because the system of credit is more developed than that of any other country, but also because its economic prosperity is more dependent upon trade and transport, and upon the exchange of manufactured goods for the raw materials and foodstuffs of the other nations, in other words, because England is bound up more with world trade than is the case with other countries. The concentration of all surplus funds in the hands of the banks has given to the English money market its predominant position in the sphere of banking, for it is not merely the quantity of existing capital but the quantity of loanable capital and the degree of willingness to lend which determines the standard of efficiency of the credit system. With the possible exception of the United States, no other nation has succeeded in mobilizing its available resources to such an extent as has been done in England through the mediation of the banks. The great expansion of British trade and shipping, as well as the outstanding industrial development in the course of the nineteenth century, are to be attributed to the facility with which capital could be raised in the London Money Market for every sort of undertaking which promised success.

There are those who see in the post-war ascendancy of Paris and New York in monetary affairs the inevitable decline of London from its nineteenth century greatness as the financial centre of the world, to which all countries looked confidently for capital and credit. Yet, if the trend of recent events offers any reliable indication, there would appear to be little danger of such an event taking place. The accumulation of huge gold reserves is not sufficient to secure pre-eminence. The vast international business carried on by the London Money Market rests on a gold reserve which would be hopelessly inadequate were it not for the widespread confidence reposed in Lombard Street. It is not by hoarding gold that other financial centres can outstrip London, but by making their money and discount markets freely available to all comers at all times, and refusing to give way to sudden panic. It is an old principle in London, learned in the hard school of experience, that the way to meet a run on banking reserves is to give credit freely to all sound

institutions requiring it This truth does not yet appear to have been appreciated by London's would-be rivals.

TYPES OF FINANCIAL INSTITUTIONS. The fundamental principle on which modern banking has been built is that of specialization which has led to the most far-reaching adaptation of banking services to the needs of modern trade. The Committee on Finance and Industry enumerates the following specialized branches of activity found in a modern financial organization—

1. Every advanced financial organization possesses a market in which funds available only for very short periods are lent out. This is designated the call-loan market. The immediate effect of an increase in the supply of credit is usually an increased flow of funds to this market, whether, as in New York, it is primarily associated with the Stock Exchange, or whether, as in London, it is primarily associated with the market in bills of exchange, i.e the discount market.

2. Every organized system possesses a market in which the supply of and the demand for short period loans is balanced. To bring short period lending into relation with short period demands for accommodation is the primary function of commercial banks.

3. Every organized system includes a market for the adjustment of the supply of and the demand for new long period capital. This is the capital market in the ordinary sense of the term, which prepares and offers new securities to those seeking opportunities for investment.

4. In addition, and as an inevitable accompaniment of the capital market, there must be an organization capable of transferring ownership rights in already existing securities. This organization is the Stock Exchange.

5. There are usually special organizations dealing with the supply of savings of a special character, or linking up the flow of savings with the demand for savings for special purposes. Into this category fall the insurance companies, the savings banks, agricultural mortgage banks, and other analogous institutions

So far as banking proper is concerned, we have in Great Britain the following types of institutions—

1. Note-issuing Banks. With the disappearance of the private note-issuing banks, the principal representative of this branch of banking in this country is the Bank of England, whose functions have already been considered. Certain of the English joint-stock banks have notes in circulation in the Isle of Man, but the total of these is insignificant. In Scotland, all the principal banks still possess the right of note issue under restrictions imposed by law, but such notes are legal tender in Scotland only.

2. Deposit Banks. These are the banks with which the public in general deal, and may be divided according to their constitution into joint-stock banks and private banks The majority of the former class are banks with limited liability, the outstanding representatives being the group usually described as the "Big Five." Banks with unlimited liability are now practically obsolete, the only independent representative of this class now remaining is the firm of Glyn, Mills & Co. Private banks, which were at one time extremely numerous, have now practically disappeared through amalgamation

3. Commercial Banks. Unlike the deposit banks, these do not find their sphere of activity in the home trade, but devote themselves chiefly to overseas trade They also operate with a larger percentage of their own capital in view of the greater risk involved. These may further be subdivided into—

(*a*) Foreign bankers and merchants.

(*b*) Foreign and colonial banks.

(*c*) English branches of foreign banks.

(*d*) Promoters, financial syndicates, companies and trusts whose activity is almost entirely outside the banking system.

Division of labour, however, has not stopped at this, for special institutions have developed for dealing in particular branches of credit for which a special knowledge of persons, goods, or locality is necessary. Thus, in Lancashire we find a small group of old-established banking houses maintaining close touch with the needs of the cotton industry Again, we find banks whose main business is concerned with the finance of British overseas trade in particular areas such as Central Europe, Russia, or the Far East.

DEVELOPMENT OF JOINT-STOCK BANKS. As a consequence of the Acts of 1709 and 1742, which stipulated that, with the exception of the Bank of England, no other company of more than six partners could issue notes or carry on a banking business in England and Wales, the Bank of England for nearly a century and a half was the exclusive ruler of the English Money Market. Against such a powerful corporation, the influence of the other banking firms, which could be carried on only in the form of ordinary partnerships with not more than six partners, was naturally a small one.

As the note issue of the Bank of England could no longer cope

with the growing business, especially in the provinces, towards the end of the eighteenth century, and still more in the years following the conclusion of the Napoleonic Wars, a large number of private persons, merchants, and traders found occasion to issue notes themselves and carry on other banking business In the particularly acute crisis of 1825, no less than 700 of these bankers became insolvent in the provinces. The terrible distress which followed this crisis induced public opinion to demand that the issue of notes in the provinces should be given into the hands of more strongly capitalized institutions. This demand was carried into effect by the Government in 1826, when banks with more than six partners were given the right to issue notes outside a radius of 65 miles from London, the latter area being reserved for the Bank of England. At the beginning of the thirties of the last century, the first joint-stock bank was established in London and was intended to develop the deposit business, after Joplin had already called attention, in 1822, to the fact that the wording of the charter given to the Bank of England referred only to the issue of notes, and did not embrace the banking business.

The Bank of England now made an attempt to have its privileges extended so as to render impossible the establishment of other banks. It did not succeed in this attempt, but, on the contrary, in the renewal of the Bank's privileges in 1833, it was expressly stipulated that "any body politic or corporate, or society, or company, or partnership of whatever number they consisted, might carry on the business of banking in London or within 65 miles thereof, provided that they did not borrow, owe, or take up in England any sum or sums of money on their bills or notes, payable on demand, or at any less time than six months from the borrowing thereof, during the continuance of the privileges of the Bank of England." This made possible the establishment of the first joint-stock bank, that is, the London and Westminster Bank, established in 1834, which is still in existence, forming part of the amalgamation now known as the Westminster Bank.

The period 1833 to 1844 is marked by the vain attempts of the Bank of England to make the development of the new competitors as difficult as possible, and it even went so far as to formulate special rules, according to which these outside banks should be fought.

The London and Westminster Bank, as the pioneer of the whole movement, was in continual conflict with the Bank of England. Difficulties arose from the fact that banks were ordinary partnerships and did not possess a separate legal identity. In a legal dispute it was not the bank, but all or some of the partners who had to appear either as plaintiff or as defendant. The most peculiar case, however, arose from the fact that clergymen were forbidden to carry on business, and that commercial companies which included a clergyman amongst their members were illegal On the occasion of a bill of exchange suit, the defendant made use of this objection, and it appeared that, for this reason, most of the new undertakings were illegal. A Bill was immediately passed to sweep away this anomaly.

It is not surprising that the chaotic legal conditions led to the growth of a whole series of fraudulent foundations which, in the difficult times at the end of the Thirties, all collapsed again, thus giving rise to distrust and a demand for further regulation. This took place in regard to note-issuing banks under the Act of 1844, promoted by Sir Robert Peel. Peel was one of the most pronounced adversaries of the joint-stock banks, and his idea was to make their establishment as difficult as possible. With this object in view, the Act stipulates that the minimum amount of the shares of newly-established banks should be £100, of which £50 at least should be paid up. The result was that the existing banks received a kind of monopoly and no new ones were established until 1862, when a new Companies Act was passed which gave companies with a minimum of seven shareholders the right of limited liability. In regard to banks, it was stipulated that businesses with more than ten partners would have to form themselves into a company in accordance with the regulations of the Act. Other numerous changes in Company Law, which are to-day summarized in the Companies Act, 1929, are of small importance to the banking community.

In spite of opposing difficulties and temporary reverses, the development of the English joint-stock banks from 1840 onwards was phenomenal. By skilful adaptation to the economic tendencies of the times, they assisted in the industrial and commercial progress of England during the second half of the nineteenth century. Moreover, by allowing interest on deposits, they attracted enormous

sums which had hitherto remained idle, but were now mobilized to assist productive activity

Of recent years, English banking has become concentrated in the hands of a limited number of large banking institutions operating through a large number of branches. Branch banking has, in this country, been carried further than in any other, the English joint-stock banks alone possessing more than 10,000 branch offices. This tendency has not failed to escape criticism on the ground, first of all, that local branch managers have not the knowledge of local conditions possessed by the old private bankers, and that, even if they possess this knowledge, their actions are so fettered by head office that they are unable to utilize it to advantage. The validity of this criticism has been challenged by the joint-stock banks, who reply that their local managers are allowed considerable latitude for the exercise of discretion. Furthermore, it is important to realize that it is essential in banking to adhere to clearly defined lending policies. Such a course of action is essential in the interests of sound business, and, as the Committee on Industry and Trade has pointed out, the convenient phrase "local elasticity" sometimes has served to cover undesirable preferences and personal discriminations.

Possibly a more serious criticism arises from the tendency towards the multiplication of competing branches, which is causing the cost of doing business to increase considerably. The number of new branches opened would appear to be greater than is justified by a spreading of the banking habit amongst the general public. On the other hand, it may be said that a branch banking system under centralized control facilitates the mobilization of funds and their direction to the most productive employment. It serves to strengthen the resources at the disposal of the bank and increases its power to assist industry.

SERVICES OF THE BANKER. We have spoken of the banker as a borrower and a lender of surplus funds, and to-day, even though his activities have extended over a far wider field, these still remain the foundation of his business. Partly on account of the growing complexity of business, and partly as the result of competition between banking institutions themselves, the modern banker now performs the following functions—

Receipt of Deposits. British banking is essentially deposit banking,

being dependent mainly on the funds which are deposited by the public, representing either savings or amounts which are not for the time being required to meet expenditure. The funds which a banker receives in this way are drawn from private individuals, business houses, and public institutions, and are of two kinds—funds deposited on current account and on deposit account. In the first case they are withdrawable on demand, whilst in the second they may be withdrawn only after notice has been given. In other words, the whole of the funds of the deposit banker are liable to be withdrawn by customers at very short notice, though, in practice, of course, withdrawals actually amount to a small percentage only of deposits. Nevertheless, bearing this possibility in mind, the deposit banker must preserve his assets in a liquid condition.

Advancing Funds. This is a form of activity which is complementary to the foregoing, and the proper exercise of this function is one of the greatest responsibilities which the banker has to shoulder. He must keep his funds in active employment, for therein rests his opportunity of making a profit, yet, for the reasons explained above, he must keep this loan fund in a liquid condition. He must satisfy himself that the purpose for which the loan is required is economically sound, and be continually on his guard against irresponsible applications for accommodation. Now, although a bank can make advances considerably in excess of the sums deposited with it, owing to the fact that a small proportion only of its deposits are likely to be withdrawn at any one time, there is a limitation on this process—

> A bank which is actively creating deposits in this way will naturally find that a considerable part of the cheques drawn against them will be in favour of other banks. It will thus lose part of its cash reserve to those banks, and must proceed to limit its loan operations if its normal cash ratio is to be maintained. In practice, therefore, no one bank can afford to pursue a policy of creating deposits by making loans or investments which is much out of line with the policies of other banks [1]

By virtue of their organization, the joint-stock banks can move capital from one district to another with extreme ease and so meet the temporary opportunities and emergencies of business, thus promoting trade development.

[1] Report of the Committee on Finance and Industry, Cmd 3897.

Making Payments. One of the most important of the services performed by the English banker is that of providing a simple and convenient method for the payment of debts. Through the operation of the cheque system, debts can be settled by transferring rights to funds from debtor to creditor by means of entries in the books of the banks. The cheque system, combined with the facilities of the clearing house enable debts to be cancelled out without the necessity for the intervention of legal tender currency. The adoption of this means of payment is conditioned by the degree of development of banking organization—the payee must not be put to great inconvenience to obtain the proceeds of the cheque. Again, the " banking habit " must be widely developed so that the control of funds can be transferred by book entries and cheques need not be " cashed " over the bank counter, thereby giving greater security. Finally, there must exist a high degree of confidence, not only in the stability of the banking system, but also as between the various members of the commercial community.

Discount of Bills. A trader who does not wish to lock up large amounts of capital in trade credits may draw bills of exchange on his debtors and present their acceptances to his banker for discount. Provided that the bill is satisfactory, the banker will discount the bill at once, so that the trader gets immediate possession of the money due to him, less an appropriate deduction for loss of interest and for commission to the bank. Much business of this type is in the hands of specialized discount houses, but the ordinary joint-stock banks find in it a profitable source of employment for their funds.

Acceptance of Bills. As pointed out in the previous paragraph, an acceptance may be discounted by a banker before the date of maturity, but the ease with which this can be done and the price which can be realized depend largely upon the reputations of those whose names appear on the bill. An acceptance by an unknown provincial trader would obviously be difficult to sell, even though he might be quite sound financially. To overcome this difficulty, bankers are prepared to accept bills drawn on them by their customers in return for a small commission expressed as a percentage of the face value of the bill. By thus accepting the bill, they give it their own backing, so that it can be discounted much more readily. Such arrangements have to be made in advance and usually

a customer requiring this service will ask his banker to open a credit for him. This is an undertaking on the part of the banker to accept bills on behalf of his customer up to the maximum amount specified, and in accordance with the terms arranged. If the bank opens a *confirmed* credit, it carries the issuing bank's absolute guarantee of payment up to the date of its expiry. An *unconfirmed* credit, on the other hand, can be revoked, with or without notice, at any time, provided that no drafts have been drawn against it.

Information and Advice. The modern banker has become more than the custodian of his customers' funds or the lender of capital. By virtue of his wide knowledge of general tendencies in the sphere of industry and trade, he has become an adviser and consultant to his clients. It should be noted, however, that it is no part of the work of a banker to promote trading schemes or to determine the channels in which industrial and commercial organization shall run. Thus, a witness before the Committee on Finance and Industry put it, "a banker must never forget that he cannot and must not be an industrialist. He can only play his real part in assisting a company by concentrating on the tasks and possibilities which present themselves from time to time in the case of every industrial enterprise. It is and must be the rule that the industrialists themselves should be responsible for the business and general management of a company and that the banker should be the adviser in matters of finance." Under this heading we may also note the information of a confidential nature which banks give regarding the standing of business houses.

Miscellaneous Services. Taking charge of valuables and securities is a facility which a banker offers to his customers. The strong rooms and safes which a banker, in the very nature of his business, is compelled to employ, constitute a convenient storehouse for those valuables which customers wish to protect against fire or theft. Bankers also act as agents, trustees, or bailees of their customers, carrying through purchases and sales of their stocks and shares, holding their securities for the purpose of collecting dividends, and receiving bills for collection on their behalf. On a customer's order, a bank will pay subscriptions to clubs, charitable institutions, and so on, at regular intervals, thus relieving him of the necessity of remembering to make such payments at the proper time.

ANALYSIS OF A BANK BALANCE SHEET. The principal sources of a banker's funds and the manner in which he is accustomed to employ them may be gathered from an inspection of a bank balance sheet. Although some variation exists in the form in which the different joint-stock banks present their trading results to the public, the following are the principal items found. On the liabilities side are shown the activities of the bank as a *borrower* and here we find—

1. Capital. This represents the permanent investment of the shareholders in the business. In general, this part of the statement resembles that of any other limited company, in that it shows the classes of shares, the amount of each class authorized and actually issued. Usually one class of shares will be partly paid-up, the outstanding liability being payable only in the event of liquidation.

2. Reserve Fund. This is a fund built up year by year, mainly out of undivided profits, to meet any possible contingencies that may arise in the future. The creation of adequate reserves is essential in any class of business, but is especially so in the case of a banking institution, where stability is desired above all things. In addition to the disclosed reserves, the banks are known to possess "hidden reserves" amounting to substantial sums. These are created by the deliberate under-valuation of assets such as investments or bank premises.

3. Dividend Payable. This comprises the amount to be disbursed to shareholders as dividends from the previous year's net earnings. The maintenance of a steady rate of dividend by the banks during a period of trade depression, when other businesses were making no profits, has been possible only as the result of a cautious reserve policy. Banking profits, as revealed by balance sheets, usually present an appearance of stability which true experience does not justify.

4. Balance of Profit and Loss Account. This is the residue of profit earned which is not immediately to be distributed nor definitely allocated to reserve. It serves as a dividend equalization fund, and is a valuable second line of defence to the general reserve.

5. Current, Deposit, and Other Accounts. Current accounts consist of money lodged by customers and withdrawable on demand. In short, they are the ordinary banking accounts upon which cheques are drawn. On the other hand, money lodged on deposit account

cannot be withdrawn without notice, but interest is paid on such balances. When large sums are lodged for fixed periods of several months, the bank may allow a higher rate of interest than usual. This last class of deposits is called "fixed deposits."

6. Acceptances and Engagements. These are in the nature of a contingent liability, the bank having made itself responsible in some way, as, for example, by accepting bills for certain obligations of customers They represent obligations undertaken by the bank on behalf of its customers, which the customers, in turn, undertake to make good to the bank. This item is balanced on the assets side by the liability of the customers to provide the funds to meet the obligations in question.

Taking now the assets or *lending* side of the balance sheet, it will be seen that liquidity is the prime consideration.

1. Coins, etc., and Balances with the Bank of England. This covers the coin and notes in the tills of the branches of the bank, and, in addition, the credit balance lodged with the Bank of England. In the United States the member banks of the Federal Reserve System are required to maintain balances with their Reserve Bank bearing a specified ratio to deposits. In Great Britain there are no such legal requirements, although the ten London clearing banks adopt such a practice. In this connection these banks publish monthly figures of reserves in cash and at the Bank of England, though, as the Committee on Finance and Industry has pointed out, the figures are not altogether what they appear to be—

> The monthly figures published by the clearing banks are not true daily averages, but are averages of one selected day in each week of the month. It seems that, in order to present a better appearance, most of the banks concerned are at pains to manipulate their balances with the Bank of England on the selected day of the week, so that they stand at a higher figure than usual. Moreover, each of the four biggest institutions pursuing these practices selects a different day of the week for the purpose, calling in loans from the money market on its own selected day, but returning them next morning in time for the next big bank to call them for its making-up day. Thus a certain part of the published reserves of the clearing banks in the shape of deposits with the Bank of England is like a stage army, the same liquid resources doing duty four times over in the course of each week.

2. Balances with and Cheques in Course of Collection on other Banks. These include certain small balances maintained with banks other

than the Bank of England, and cheques on other banks which, although credited to the payees' accounts, are still awaiting presentation. These claims on other banks usually amount to about $3\frac{1}{2}$ per cent of the deposits.

3. Money at Call and Short Notice. This consists of loans to the money market, that is, to bill brokers, stockbrokers, discount and other financial houses for short periods It earns only a low rate of interest, for example, weekly loans to bill brokers are made at 1 per cent below Bank Rate, but it has the great advantage of being lent against security of the highest class and of being recoverable within a very short time. Under the same heading we may place Treasury Bills. These are in the nature of promissory notes sold each week by the Government to the banks and others These must be paid off at their face value by the Treasury at a fixed time after their date of issue. The price at which they are sold is determined by competition between the buyers, but it is always less than their face value. The difference represents the cost to the Treasury of borrowing money in this way and also the profit to the buyer.

4. Investments. These consist of a mixture of short-dated and long-dated bonds and stocks, mainly British Government securities. The bank's policy in regard to these assets is essentially conservative; the investments are selected most carefully, and in all cases valued in the balance sheet below market price.

5. Bills Discounted. The nature of these has already been discussed. They include first-class bills bought in the money market or discounted by the bank for its customers. They carry responsible names and automatically become cash, the maturities being so arranged that large amounts fall due for payment from day to day.

6. Advances to Customers and Other Accounts. Under this heading is included every kind of loan made by a bank to its customers It includes large advances to trading concerns and the small overdrafts arranged for private customers. Loans to all classes find their place here, whether they are secured by the deposit of collateral or the guarantee of a friend, or whether they are unsecured and dependent upon the good faith and reputation of the borrower.

7. Liabilities of Customers for Acceptances. This is the counterpart of the item "Acceptances and Engagements" appearing on the liabilities side of the balance sheet.

8. Bank Premises. This figure represents the value of the premises owned by the bank and its branches, and is usually much below their true value.

THE BANKERS' CLEARING HOUSE. As we have already seen, one of the most notable services which the modern banker performs on behalf of his customers is that of providing them with an efficient means of making payments. It is one of the functions of a monetary system to provide the community with a medium of exchange which can be offered in payment for goods and services, and, in order to facilitate this process, most governments enact that certain forms of currency shall be full legal tender. Where this is the case, the offer of legal tender currency to the exact amount of a debt is a full legal answer by a debtor to a charge that he has failed to meet his obligation. But payment in legal tender currency may prove to be an inconvenient and cumbersome method of making payment. Suppose, for example, a merchant in Cardiff wishes to make a payment of £5,000 to someone in London and can make it only in legal tender currency. He will have to send bank-notes, and, assuming that he makes payment by sending five £1,000 Bank of England notes he will be compelled to take precautions against loss by insuring the package. This will make the process of payment somewhat expensive and must in consequence check the development of trading activity between places which are some distance apart.

Fortunately for the development of modern business, creditors do not usually insist upon their strict legal rights to payment in legal tender currency, so that the modern banking system has been able to evolve a more convenient method of payment in the cheque system. By this system it is possible to create a single credit instrument adaptable in amount to the needs of each particular transaction. In other words, the process of drawing a cheque for £50,000 presents no greater difficulty than drawing one for £5 12s. More than this, a cheque can be drawn in such a way that no person can obtain the proceeds other than the one for whom they are intended. For the debtor, therefore, the cheque possesses the dual advantage of convenience and safety, whilst from the standpoint of the community it represents a very substantial measure of economy. If all debts had to be paid in legal tender currency, a note circulation many times greater than that of the present day would have to be

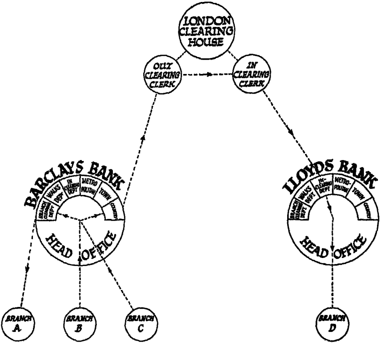
maintained. Indeed, were cheques to cease to be available, the currency in existence would be sufficient only to carry on a very small fraction of the business of the country.

Without entering into any legal technicalities we may regard a cheque as an order issued by a customer to his banker to pay a certain sum of money to a person named on the cheque, that is, the payee. The customer of a bank has an account which gives him the right to demand a certain quantity of money and the cheque which he draws upon his banker operates as an intimation that he wishes to surrender his rights to a certain amount of these funds in favour of a third person. The settlement now takes the form of a book entry in the ledgers of the bank—the account of the debtor is reduced and that of the creditor is increased—and the debt is thereby extinguished. We have to examine the process whereby this takes place.

Let us begin with a simple case. X and Y are both customers of the same branch of Lloyds Bank in Cardiff, and X owes Y the sum of £100. In satisfaction of this debt X hands Y his cheque on Lloyds Bank for the amount and Y pays it in to be credited to his account. Since X and Y have accounts at the same branch, the subsequent procedure is very simple. The ledger clerk debits the account of X with £100 and credits that of Y with a like amount. Hence, the right which X formerly possessed to demand £100 from Lloyds Bank has now been transferred to Y, and the debt of X to Y has been settled by two book entries without any employment of legal tender currency at all.

But such a case as this does not occur very frequently. Let us now assume that X and Y are both customers of Lloyds Bank, but that X is in Cardiff and Y in Manchester. X now posts his cheque for £100 to Y who pays it in. The cashier examines it to see if there is any obvious irregularity and then stamps the bank's name and branch on the cheque for purposes of identification. All cheques received during the day are sorted and those drawn upon other branches of Lloyds Bank are kept apart. Every night they are posted to head office where they are passed to a branch clearing department which deals with cheques drawn upon the bank's own branches. In the course of the day numerous other cheques drawn on the Cardiff branch will come in, both from other branches of

Diagram Illustrating the Clearing of Cheques



The above diagram illustrates the process of clearing a cheque. A customer of Barclays Bank at a country branch *B* pays in a cheque drawn on branch *D* of Lloyds Bank The cheque is sent up to head office where it passes to the out-clearing department for "country" cheques. From this department the cheque is taken to the London clearing house, where the out-clearing clerk for Barclays Bank hands it to the in-clearing clerk for Lloyds Bank. The cheque passes through Lloyds in-clearing department and is sent to branch *D* on which it is drawn If it is in order, branch *D* debits the customer's account with the amount of the cheque, thus closing the transaction. If, for any reason, payment cannot be made, the cheque is returned direct to branch *B* of Barclays Bank.

If a cheque is paid in at branch *C* of Barclays Bank, payable at branch *A* of the same bank, it is forwarded to the branch clearing department at head office which transmits it to branch *A*

Lloyds Bank and from other banks as well At the end of the day these will be posted to Cardiff. Upon receiving the cheque drawn by X, the Cardiff branch will debit his account, whilst the Manchester branch will already have credited Y's account. Here, again, the debt has been settled by book entries in different towns.

Suppose, now, that Y in Manchester has his account with Barclays Bank. Upon receiving the cheque from X, drawn upon Lloyds Bank he pays it in and, in due course, it is credited to his account. How, then, does Barclays Bank collect the amount of the cheque on his behalf from Lloyds? For the purpose of collecting the claims which the customers of one bank have on those of another, there has been evolved the institution known as the Bankers' Clearing House. This is an institution where the representatives of the banks can meet together, with the object of setting off the claims of one bank against the counter-claims of another. If, for instance, bank A has claims on bank B amounting to £5,000,000, whilst bank B has claims on A for £5,500,000, then the position between the two of them can be adjusted by a payment of £500,000 by A to B. Debts amounting to £10,000,000 have been automatically extinguished without any payment at all. Clearing facilities were officially established in 1775 amongst the London bankers, though there is evidence of a clearing system even in the seventeenth century. Thus, in the reign of Charles II the goldsmiths kept accounts with one another and settled balances periodically in coin. It was not until 1854 that the joint-stock banks became members, and even then they secured the right only by a threat to establish facilities of their own. In the same year it was laid down that every member must keep an account at the Bank of England so that differences might be settled by cheque and not by notes as was formerly the case.

Returning now to our example, all cheques paid in to the Manchester branch of Barclays are sorted into bundles according to the bank on which they are drawn, and each is further subdivided into three classes—one for its "Town" branches, one for its "Metropolitan" branches, and one for its "Country" branches The London clearing is divided geographically into these three sections. Town branches are those which are situated within ten minutes' walk of the clearing house; Metropolitan branches are

those within thirty minutes journey, whilst country branches include all others. To make it easier to sort cheques according to this classification, cheques are distinguished by the letters "T," "M," or "C," printed in their left-hand bottom corners. Upon arrival at head office the bundles of cheques from the branches are sent over to the Bankers' Clearing House from the out-clearing departments, of which there are three, corresponding to the above divisions. To each bundle of cheques there is attached a list, known as a "charge," giving the amount of each cheque together with the total of all cheques in the bundle.

Membership of the London Clearing House is restricted to ten of the big joint-stock banks. The representatives of these banks meet there daily and exchange the bundles of cheques. The clerks receiving the bundles, known as *in-clearers*, proceed to list the cheques afresh upon an in-clearing sheet in order to agree the total, if possible, with the charges attached to the various bundles. In the event of any discrepancy, the in-clearing totals are assumed to be correct for the time being, and any adjustment is made later. The cheques received are now sent to the in-clearing department at head office, where the cheques are sorted and posted off to the branches. Here, they will be carefully examined and debited to the customers' accounts. If, for any reason, payment has to be refused, the branch will post the cheque *direct* to the branch presenting it for payment Thus, in our example, the Cardiff branch of Lloyds Bank will post an unpaid cheque direct to the Manchester branch of Barclays. Upon receiving it, this branch will re-debit the customer's account with the amount of the cheque and return it to the customer with some conventional statement indicating the reason for non-payment.

At the close of each day's operations at the Clearing House a balance is struck between each bank's in-clearings and out-clearings. According as its in-clearings or its out-clearings are the greater, it pays into or receives the difference from the Clearing House. As already stated, each clearing bank and also the Clearing House itself, has an account with the Bank of England and clearing settlements are effected by drawing on or paying into this account. The receipts and payments of the Clearing House itself will, of course, exactly cancel out.

There are, however, in the City of London, numerous banks and

other financial institutions, on which cheques are drawn, which are not members of the Bankers' Clearing House. Cheques drawn upon these institutions are dealt with by the walks department at head office. Representatives of this department present these cheques at the banks concerned and receive, in exchange, cheques drawn by these institutions upon the particular clearing bank which acts as their agent. These cheques are passed through the clearing in the usual way. In like manner, any cheques received by such banks are transmitted to their agents for collection for their account.

Collection of cheques through the Clearing House does not occur in the case of a cheque drawn upon a branch in a town and paid into another bank in the same town. In order to simplify the process each bank in turn holds a local clearing which is attended by representatives of all banks in the town. Clearing differences are settled through head office In addition, eleven provincial cities contain Clearing Houses of their own.[1] Most of these contain branches of the Bank of England so that clearing differences can be settled in the same way as in London. Where no branches of the Bank are established, differences are settled through head office as in the case of local clearings.

LENDING POLICY OF THE BANKS. As indicated already, one of the principal criticisms which has been levelled against the system of branch banking in this country is that branch managers are fettered in their decisions with regard to advances by the head office. It has been said that the elasticity of the present system is much less than that which prevailed in the days of the private banks. In evidence given before the Committee on Finance and Industry it was, however, pointed out by the chairman of Lloyds Bank that the procedure governing the making of advances is very much the same as it was with the private banks. In the case of Lloyds Bank the general supervision of the bank's advances is in the hands of controllers who are stationed in London and at the district offices, these officials being directly responsible to the joint general managers, of whom there are four, in charge of the advances of the bank. The manager of one of the larger branches will usually have the power,

[1] Birmingham, Bradford, Bristol, Hull, Leeds, Leicester, Liverpool, Manchester, Newcastle-on-Tyne, Nottingham, and Sheffield.

at his discretion, to make advances up to a certain limit, say £1,000. If the amount required is in excess of this limit he forwards the particulars on a form of application to the district office. The application is considered by the controller who is in charge of that particular district and, if approved by him, it passes on to the general manager who is in control of the same district. Provided that the required advance does not exceed £15,000, it will be sanctioned and the branch notified accordingly. On the other hand, if it exceeds this amount, then the matter has to be brought up before the board or a committee of the board for approval.

In certain districts where amalgamation takes place, the district manager is assisted in his decisions by an advisory committee which, in some cases, is composed of members of the former local board of directors. These men, on account of their local knowledge and contact with the people, give valuable assistance in this work. Again, the local branch manager to whom application is made in the first instance is, not infrequently, the same man who was manager prior to the amalgamation. In any case, he has just the same local knowledge and sympathy in regard to the requirements of the district as the servant of a private banking firm.

In view of the nature of British banking—where a large proportion of deposits are repayable on demand or at short notice—the type of advances which receive the most favourable consideration are those from trading customers who want temporary accommodation in connection with their ordinary business. Advances for capital expenditure are made with greater reluctance, but it does not follow that they are invariably refused. Each case is considered on its own merits, special attention being given to the possibilities of the eventual liquidation of the loan. An advance against the mortgage of an estate, for example, is not regarded as a suitable type of business for an ordinary commercial bank in this country. Yet, if a customer wants an advance for the purpose of developing an estate or for building houses with a view to selling them, then the bank is prepared to consider the request. In granting the advance it will have to consider whether the expectations of the borrower are likely to be realized because, if they are not, it will not be safe to grant the accommodation.

In the case of businesses suffering from the effects of trade

depression seeking for an advance to enable them to tide over until conditions improve, the case is more difficult. The bank will require to know something of the past history of the concern as well as of its future prospects. It will have to investigate whether its present difficulties are due to a general trade depression or to faults of business policy or management from within. In the course of rendering such assistance it may happen—and indeed, frequently has happened in the post-war period—that the banks, in the course of performing what they deem to be their legitimate functions, have been led involuntarily into the position of investment bankers In other words, they have funds which are "frozen" and cannot be liquidated owing to trade depression. In consequence it has been said that the banks have tended to prolong the lives of these concerns when, from the point of view of the industry as a whole, it would have been better had they gone into liquidation. In this connection, Professor O. M. W. Sprague[1] advanced the opinion that the great strength of the British banks may constitute a defective quality. They are not impelled, for the sake of self-protection, to take speedy action in liquidating a bad position, by eliminating from the industrial field a badly-managed undertaking, as they might be if the banks were less strong. In the United States, where the banks are much more numerous, it is customary for a business concern of any size to borrow from a number of banks A business concern may be borrowing from a bank in New York, one in Boston, one in Philadelphia, one in Chicago, or from several banks in any of those cities. This imposes upon the credit departments of these various banks the necessity of watching their debtors in order to protect their own interests. Again, the fact that the bank is usually an unsecured creditor in the United States creates caution in the granting of advances and tends to enforce an earlier liquidation than in this country.

BANKING AND AGRICULTURE. In the midst of the storm of criticism to which British banking practice has been subjected in recent years, its attitude to the peculiar financial problems of agriculture has not escaped attention. Abnormal war time conditions

[1] See Minutes of Evidence taken before the Committee on Finance and Industry (Vol. II)

brought temporary prosperity to the British farmer, but, with the coming of peace, the history of the industry tells a story of unbroken depression. It would be out of place to attempt any analysis of the numerous causes which have combined to produce this undesirable situation, but not least amongst them may be mentioned the vital question of finance Now, in common with every industry, the farmer requires financial facilities of two kinds, namely—

1. **Short-term Credit** to provide him with the necessary working capital for current expenditure on seeds, fertilizers, wages, and marketing his produce.

2. **Long-term Credit** to provide fixed capital which may be sunk permanently or for long periods in the acquisition or improvement of land and the purchase of equipment.

Now the agricultural industry in this country is run on individualistic lines. The movement which has given over the field of manufacture, commerce, and public utilities to great corporate undertakings, working on the principles of joint-stock, has left agriculture untouched. Hence, for the most part, the elaborate financial machinery which assists in providing the capital requirements of undertakings engaged in these other spheres of economic endeavour, is not available to the farmer. He is, therefore, either thrown back on his own resources or compelled to resort to various makeshift methods, usually of a highly unsatisfactory nature, to obtain the accommodation which he requires. For the most part, the post-war depression has exhausted the personal resources of the farming community, which is, therefore, compelled to look elsewhere for the satisfaction of its requirements. The farmer has in many instances obtained working capital in the form of credit from tradespeople, auctioneers, and landlords, thereby intensifying his difficulties in many instances. It is frequently almost impossible to estimate the cost of such credit, whilst the enterprise of the farmer is fettered by the arrangements which he is compelled to enter into with tradespeople, who are, after all, concerned more with the success of their own enterprises than with that of the farmer.

In 1926, the Ministry of Agriculture published a Report on Agricultural Credit, which examined exhaustively the whole question. It refuted a common criticism that the new amalgamated

joint-stock banks were less sympathetic and more rigid to the agriculturist than were the old private banks, and that local bank managers were less acquainted with the needs of farming than was formerly the case. It was pointed out that relatively more agricultural loans were, in fact, outstanding to-day than in the days of the small private banks The banks are at all times anxious to maintain and develop their agricultural connections, and are prepared to help as much as possible consistent with their responsibility to their depositors. Nevertheless, the Report confirmed the generally accepted view that there was room for a very considerable development of the facilities available to agriculture—

Banks frequently lend on their personal knowledge of farmers without a definite charge upon their property, but the extent to which this is done is limited. The farmer who has title deeds, share certificates, or a life insurance policy to deposit with his bank as collateral has no difficulty in securing substantial advances against these securities. The small tenant farmer, however, whose main assets are his growing crops and other stock, *has* difficulty in obtaining adequate bank accommodation.

In view of the inability of the industry under existing conditions to offer the wealth it produced—its stocks and its crops—as security for advances, the Report advocated legislation enabling the banks to take a charge on certain classes of farm produce as security for advances. By this means it was recommended that the machinery of short-term credit should be concentrated in the hands of the banks where the cost of credit is known, and where the farmer can escape from the abuses which the tradesmen credit system often involves. These proposals were embodied in the Agricultural Credits Act, 1928, which had as its objects "to secure, by means of the formation of a company and the assistance thereto out of public funds, the making of loans for agricultural purposes on favourable terms and to facilitate the borrowing of money on the security of farming stock and other agricultural assets, and for purposes connected therewith."

The new company, the Agricultural Mortgage Corporation, was created in 1928 to give effect to the terms of the Act. The share capital—the dividend on which was limited to 5 per cent—was subscribed jointly by the Bank of England and other leading banks, which agreed to further the activities of the Corporation by

placing their machinery at its disposal. The Government agreed to advance an amount equal to the paid-up capital, but not exceeding £1,000,000, free of interest, whilst it undertook to underwrite the first £5,000,000 of debentures issued and invest therein £1,250,000. There has, since the inception of this new undertaking, been a widespread demand for the facilities which it offers, and there is evidence that it has rendered material assistance in agricultural finance.

BANKS AND INDUSTRIAL FINANCE. The general financial policy of the banks in the sphere of industry has also been the subject of acute controversy. In the course of a prolonged period of trade depression, during which the majority of concerns have been faced by heavy losses or, at least, sadly diminished profits, the banks have continued to accumulate large reserves and maintain a relatively high rate of dividend upon their share capital. The opinion has been expressed in many quarters that this position indicated a failure on the part of the banks to fulfil one of their principal functions—the provision of funds at a reasonable rate for industry and commerce, and that economic activity was being fettered by the excessive charges which the banks were levying for the accommodation which they were providing. On the other hand, a counter-criticism was advanced by the Committee on Industry and Trade, that the banks had done much harm to the permanent interests of British industry by supporting weak undertakings which had better been allowed to go into liquidation.

But, more recently, a new point of attack has been adopted. For some ten years after the declaration of peace the British business community as a whole accepted the prevailing industrial and commercial depression as a transitory phenomenon—as something which would pass as world economic conditions slowly reverted to normal. But, as time went on, there came a growing realization that post-war "normality" was going to be something quite different from 1913 conditions. For more than four years one-half of the world had occupied itself in the organized destruction of economic wealth, and had then spent ten years in the work of reconstruction, so that by 1928 it would appear that the world had, roughly speaking, made good its losses. The new position was, however, vastly different from the old. Manufacturing industry, which had become increasingly competitive even in pre-war days, had become disseminated in many

countries under the shelter of tariff walls. Old markets had gone and new ones had sprung into existence, but the requirements of the new were far from being the same as those of the old. Worst of all, the position of the so-called " basic " industries—coal, steel, and textiles—appeared to have receded in favour of newer " luxury " trades. After the World Economic Conference, in 1927, in particular, it came home that what British industry needed was a new orientation, and for the first time that ill-used word " rationalization " became current.

British industry stood in need of a process of intensive reconstruction. The productive and marketing methods of the " basic " industries were seen to be out of harmony with the economic environment of the post-war world. Existing enterprises needed reconstructing in various ways, partly to eliminate destructive competition, and partly to free them from the crushing burden of excessive capitalization. Alterations in the technique of production had caused the obsolescence of existing plant and equipment, thereby necessitating the scrapping of the old, with a consequent sacrifice of capital investment and the incurring of a heavy capital expenditure, if the enterprises were to be placed on a par with their overseas competitors. But the truth of the old saying that nothing succeeds like success was found to be only too true. A successful enterprise of good earning power will find no difficulty in securing such funds as it needs for further expansion, but one which has suffered from the effects of depression no longer attracts the same measure of public confidence.

Now, in other countries, particularly in France, Germany, and the United States, it is claimed that the difficulty of raising new capital is not nearly so great, on account of the closer connection between the banking interests and industry. Thus, in evidence given to the Committee on Finance and Industry, it was said—

> Scarcely a single important company in Germany has been founded without the collaboration of a bank. Whether it is a case of converting a private firm into a limited company, or of exploiting a new invention by establishing a new enterprise, the assistance of a bank is always invoked. The bank examines the situation and, when necessary, obtains reports from experts in the particular line. If the bank, after examination, decides to found the company, it draws up the scheme of financing, determines the amount and type of capital to be issued, and then, in some cases, itself takes a part of the shares into its security

portfolio with the idea of issuing them at a later date In this way the founding bank becomes at the same time the issuing bank, the latter functions beginning, however, only with the introduction of the shares to the Stock Exchange through the intermediary of the bank.

The Committee, in its consideration of desirable credit facilities, drew a distinction between intermediate credit and long-dated capital. Intermediate credit was defined as that advanced for periods ranging from one or two up to five years, and is of three main classes, namely—

1. **Credit for Hire-purchase Sales** which covers the sale of various classes of goods of which the legal ownership can be retained by the seller until payment is completed In this respect, adequate facilities appear to exist, but it is doubtful whether the public make full use of them. From recent experience it seems that the risk of loss in the granting of such credits is small, while on the other hand their value in stimulating home consumption should be great.

2. **Advances Against Deferred Payments** which cover the sale of larger units such as ships, coke-ovens, or machinery which, after erection, is not removable, so that the ownership passes, in fact, from the seller. With the growth of the mechanization of industry, the demand for longer credits for financing the production and sale of machinery appears to be growing. The foreign buyer often wants two or three years before he can complete his payments, and, therefore, contracts are likely to go to those sellers who can provide sufficiently long credit. In this respect, the facilities offered in this country appear to be inferior to those abroad.

3. **Credit for Long-term Contracts** which covers large contracts for railways, harbours, roads, and so on. For the most part such contracts are undertaken on behalf of Governments or municipalities, and as the work is often extended over a number of years, loans to finance them are required only gradually, payment usually being made at previously defined stages of the work. This calls for longer credit than British banks are accustomed to give, but in the opinion of the Committee on Finance and Industry it should be possible to develop such facilities to put British contractors on level terms with their foreign competitors

BANK OF ENGLAND AND INDUSTRY. As already pointed out in the previous chapter, one of the primary functions of a central

bank is to maintain its assets in the most liquid state possible. It is no part of its duty to finance industry directly, but to safeguard the central cash reserves and so make secure the basis on which the commercial banks may be able to discharge that function in so far as it is the duty of commercial banks to do so. The exceptional circumstances of the post-war period have led the Bank of England to depart from this rule of non-intervention in industry. For a time its operations consisted mainly of interviews and discussions with representatives of many important industries. It was soon realized, however, that action would have to take a more definite form, and, in 1929, the Securities Management Trust was registered as a private company, in which the Bank held the whole of the capital. This organization came into being because, owing to the abnormal conditions, the Bank came into possession of certain securities, acquired for particular purposes. The mere fact of having acquired these securities brought the Bank into contact with industry. The Securities Management Trust was established to take over this business and conduct it in another building as a matter quite distinct from the Bank's ordinary functions, the business being entrusted to persons having special qualifications to deal with it.

For this company were obtained the whole-time services of various experts—technical, accountancy, legal, and labour. These are engaged as directors of the company, and devote the whole of their time and energies to it. The objects of the undertaking as set forth in its memorandum are to advise industry, to examine schemes for reorganization, and to ensure that schemes are of such a nature as to justify appeals for financial assistance in other quarters The Bank itself had no intention of finding money, nor was it going to attempt to induce others to provide it simply to support inefficient or uneconomical industries. When schemes are brought to the company, they are examined by the expert directors who act in an advisory capacity. When the schemes have received their approval, they are submitted to the full directorate of the company If this body considers that they are to the public interest, the Bank may be prepared to make a temporary advance of a limited sum of money until such time as the industry can appeal for permanent investment credit through the usual channels. As

soon as an industry has been put on its feet and can feel assured that it is in a condition in which it can fairly appeal for investment credit, the money advanced must be released so that it may be available, if necessary, for the assistance of other industries.

With a view to bringing about a closer relationship between industrial and financial interests the Bankers' Industrial Development Company was formed in 1930. This, again, is a private company which was brought into being by the efforts of the Governor of the Bank. It has a capital of £6,000,000 which is divided into two classes of shares; £4,500,000 is subscribed by practically all the banks and finance houses of the country, and £1,500,000 by the Bank of England. The life of the company is to be for five years only, although it can be prolonged by special resolution. The nominal capital of the company cannot be called up to the extent of more than 25 per cent except in the event of a liquidation, and even then those shares held by the Bank of England must be fully paid up before calls can be made on the other subscribers in excess of the 25 per cent. The object of the company, as laid down in its memorandum is "to receive and consider schemes for the reorganization and re-equipment of the basic industries of the country when brought forward from within the particular industry, and, if approved, to procure the supply of the necessary financial support for carrying out the scheme."

This undertaking came into existence as an attempt to fill up a gap in the machinery of investment and was not intended to make any permanent alteration in the financial structure of the money market. It was adopted as an expedient to assist in surmounting abnormal conditions. It was created through the influence of the Bank of England rather than through a commercial bank, because it was found that the former institution alone possessed the necessary influence to take the lead It was possible for the Bank to step in with such a proposal without arousing the same antagonism as might have been called forth had the suggestion emanated from a joint-stock bank. Again, those connected with the Bankers' Industrial Development Company have been at pains to make it clear that, although the Bank of England is interested in the company, the two are not associated in any real degree. The two boards of directors are separate and the company does not act under

the influence of the Bank. Herein it differs from the Securities Management Trust which is controlled entirely by the Bank.

The initiative for submitting schemes of reorganization must be taken by the industry concerned, and, when submitted, the scheme has to be examined in detail. This is work which can proceed only slowly, as the expert staff at the disposal of the company is necessarily limited. Once a proposition is found to be worthy of support, then the company attempts to construct a security which can be offered to the public for subscription. It is hoped that schemes for the reorganization of depressed industries will receive a greater measure of public support if they are backed by a responsible body which has submitted them to an impartial and searching examination.

The Committee on Finance and Industry, whilst appreciating the need for such a concern as the Bankers' Industrial Development Company, were of opinion that it should be definitely separated from the Bank of England. They considered that, in certain respects, British financial organization is more suited to the provision of capital for overseas loans than for industrial finance. There is scope for the foundation of a number of institutions engaged in industrial finance and having such functions as—

> Acting as financial advisers to existing industrial companies; advising in particular as to the provision of permanent capital, its amounts and types; securing the underwriting of and issuing the company's securities to the public and, if necessary, assisting previously in arranging for the provision of temporary finance in anticipation of an issue, assisting in financing long contracts at home and abroad, or new developments of an existing company, or founding companies for entirely new enterprises, acting as intermediaries and financial advisers in the case of mergers, or in the case of negotiations with corresponding international groups; and generally being free to carry out all types of financing business.[1]

Yet, it was recognized that the success of institutions directing themselves to the interests of British industry must depend finally on the profit-making capacity of that industry. They may help by financial assistance and co-operation, but industrial problems must in the main be solved by industry itself. In fact, all those measures which are usually described under the name of "financial

[1] Report of the Committee on Finance and Industry

reorganization" may easily prove to be futile in the absence of preliminary technological investigation and advice Technical and financial reorganization should proceed together.

TEST PAPER 5

1. What are the functions of a modern bank? Explain what a joint-stock bank does with its depositors' money.
2. Mention some of the peculiarities of a banker's business which distinguish it from that of other commercial houses. What are the chief circumstances which should influence the banker in determining the amount of his reserve?
3. Endeavour to show how the employment of "credit" instruments has been largely responsible for the rapid development of our Banking System.
4. "The distinctive function of a banker begins as soon as he uses the money of others." (Ricardo.)
   "The banker is primarily one who offers facilities for clearing or setting-off debts." (Hawtrey.)
   Discuss these two views of the essential functions of banking
5. Discuss the conditions of the bank amalgamations which have created the "Big Five."
6. Give your views as to the advantages and disadvantages of the absorption of private banks by a few large joint-stock banks, and state whether you consider this process to be detrimental or otherwise to the banks themselves and to the trading community.
7. Illustrate, by reference to the balance sheet of a modern joint-stock bank, the functions of a modern banker as a professional borrower and lender.
8. Enumerate the items which usually appear in the balance sheet of a joint-stock bank To what points would you direct attention in order to estimate the bank's soundness and financial stability?
9. What classes of banking assets are to be considered the most liquid? Discuss the question from the point of view of the individual bank, and from that of the banking system as a whole
10. "Bankers are borrowers, not custodians of their customers' money." Explain carefully the meaning of this quotation.
11. If all banks in a country made a definite rule to lend 90 per cent of their deposits on any good security, and regulated the rate of interest to enable such a proportion of their deposits to be put out on loan, what do you imagine would be the ultimate effect on the financial and monetary state of the country? If possible, illustrate your answer historically.
12. Outline the services which the banks render to the business community. In what way, if any, do you consider the banks "create money"?
13. Mention various possible explanations of an increase in the total of bank deposits in England. How far can this be regarded as a sign of prosperity?

14 Write a short account of the structure of the English banking system, and of the way in which it helps British trade and industry

15. Discuss the financial problems of agriculture, and consider what steps have been taken in this country to meet them.

16 "Every industrial and commercial company has a double financial problem, namely, to provide itself with adequate permanent capital and to obtain, as occasion warrants, temporary or seasonal credits"

Discuss the adequacy of existing financial organizations in this country to provide these facilities

17. Indicate briefly what, in your opinion, is the most desirable relationship between the banker and the industrialist.

18. Write a short account of the work of the Bankers' Industrial Development Company.

CHAPTER VI

THE MONEY MARKET

When we speak of a money market—such as the London Money Market—the impression produced is likely to be misleading. In the first place, when we refer to a market we usually have in mind a group of traders carrying on business in a definite locality and, not infrequently, confined within the four walls of some building In actual fact, there is no place set aside in the City of London for the purpose of negotiations and transactions in money. Secondly, the commodity which is dealt in is not money in the sense of legal tender currency, but is *rights to money and capital* in the form of credit instruments of every description. The money market is essentially an economic market, and is an area in which the demand for credit is enabled to establish contact with the supply. The money market is therefore a somewhat abstract conception, and the institutions which comprise it are not easily defined In the words of Lavington—

> It consists of a nucleus of specialized institutions, such as the banks, the market for negotiable securities, the bill brokers and the trust and finance companies, which form the inner market, or Money Market proper But it extends beyond this centre, forming an outer market which includes the work of the solicitor who arranges for the transfer of capital on mortgage, of the provincial broker who promotes the sale of new and old securities, of building societies which facilitate investment in houses, of the system of trade credit, and of those less definite arrangements for facilitating the movement of capital which, as the market is extended outwards, become more and more closely bound up with the processes of trade and industry [1]

We find a money market of some description located in most areas where economic development has proceeded beyond a primitive stage, though its importance and the degree of efficiency with which it conducts its operations are subject to wide variation. In fact, the degree of financial organization of any region varies in close relation to its economic development. As communities become less self-sufficient and begin to appreciate the benefits of specialization with

[1] *The English Capital Market.*

its inevitable concomitant—exchange—then, of necessity, their financial organization must also develop. At first, the machinery of the market is planned to deal with credit instruments which dispense with the transmission of coin and bullion in the settlement of debts, the most notable example being, of course, the commercial bill of exchange. But at a later date, the expansion of the size of the unit of business enterprise necessitates the introduction of the negotiable share, and throws upon the financial organization the duty of providing a market both for new and old negotiable securities of this type. With this development we obtain the nucleus of a money market in the modern sense.

RISE OF THE LONDON MONEY MARKET. Of all the countries in the world, Great Britain was, during the nineteenth century, the most interested in international finance and investment, and, quite early in the century, London came to the fore as the financial capital of the world. In the course of her rise to that pre-eminent position, there gradually evolved that complex group of specialized financial institutions, which, even to-day, has no exact parallel in any other centre, and to which we refer as the London Money Market. There had, in the past, been great financial centres with a European reputation—Florence, Genoa, Augsburg, Antwerp, and, in the seventeenth and eighteenth centuries, Amsterdam. In this last centre, financial operations had been systematized to a greater extent than had hitherto been the case, for the Dutch understood the use of negotiable instruments and established a market for dealing in them.

During the eighteenth century the prosperity of Holland suffered a disastrous, decline whilst Great Britain consolidated her position as a commercial nation. In consequence of the Navigation Acts, England freed herself from dependence on the Dutch carrying trade, and during the eighteenth century there commenced an accumulation of capital which gave promise of financial independence as well. The money market which emerged in London in the early nineteenth century, as the result of a series of revolutions, both political and economic, was only about one hundred years old. The Bank of England was already the central institution of the market, controlling as it did the note issue in London, managing the Government debt, marketing the short-term bills of the Government, in addition

to rendering its services to the banking and mercantile interests. There were many merchant houses, with extensive connections abroad, whose acceptances and drafts gave rise to an extensive structure of commercial paper, for which the Bank of England frequently provided discount facilities.

Private banking firms, the successors of the London goldsmiths, had conducted their business in some cases before the foundation of the Bank. They had now began to form valuable connections with the country banks engaged in the finance of domestic trade. Indeed, these "country rag merchants," as they were described by Cobbett, came to provide the monetary system throughout the area in which they operated by drawing sixty-days' bills on their correspondent bank in London. After 1773, the brokers and jobbers of Jonathan's Coffee House, laid the foundations of the Stock Exchange though this was not recognized as a socially desirable institution until after the Napoleonic Wars. At that time the bulk of their dealings were in Government stocks, and it was not until the first decade of the nineteenth century that commercial stocks were dealt in, such as those of canals, turnpikes, and coal-mining companies.

This oddly-assorted community of financial dealers attained cohesion under the stimulus of war. The private banks and the merchant bankers of London now came to the fore, for their co-operation was essential to the Government in the conduct of the War.

> Nearly the entire cost of the War was to be met abroad. In gold or supplies, the proceeds of loans or taxes must be at the disposal of Great Britain and her Allies in the field. Only merchants, through their foreign correspondents, were able to perform this service. They could meet pay-rolls in Flanders out of Mexican dollars coming in payment for calico delivered in Spain. They could assemble cloths from Yorkshire, sabres and muskets from Sheffield, and horses from Ireland, and deliver them in Trieste for an Austrian campaign.[1]

As trade increased, the number of bills of exchange in circulation increased as well. Funds, which could not find profitable employment, accumulated in the agricultural districts, whilst the manufacturers of the north were constantly pressing their banking institutions for loans which could be provided only with difficulty. As a result of this pressure, the northern bankers attempted to procure

[1] L. H Jenks, *The Migration of British Capital to 1875*.

liquid funds by discounting commercial paper in London. Finally, there came into existence specialized bill-broking firms who could examine the merits of this commercial paper and, on the strength of their recommendation, could bring buyers and sellers of bills together thus diverting liquid capital to profitable employment.

> Money left the agricultural districts of the south-east and went to assist the development of the manufacturers of Lancashire and Yorkshire. London served as a sort of natural balance to establish an equilibrium of supply and demand between the banks of the agricultural and those of the manufacturing districts.[1]

Upon the termination of the French Wars, the London Money Market turned its attention increasingly to overseas investment. It was becoming clear that the economic development of Great Britain would be dependent upon the expansion of her markets overseas, and that these could be developed only through investment. Between the end of the Napoleonic Wars and 1825 there was a mania for foreign loans in Europe, whilst in the twenties the revolted Spanish colonies in South America sought British funds as a means of consolidating their position. These loans, particularly in Latin America, were made with little discrimination, so that by 1827 the majority of the borrowing Governments were in default. For many years, the finances of these states were in a condition of chaos, whilst the stocks which the original investors had purchased passed at low prices into the hands of professional speculators. In many cases, too, the funds which were advanced brought little permanent benefit to the countries which received them. Those advanced to stable European states stimulated economic development, but often it was true to say that—

> The evident political corruption, the constant agitation, the changes and insecurity which the best of these States exhibits, may, in some degree, have been produced by the demoralizing effects of the capital which has been obtained under false pretences, and which has been squandered for dishonest or facetious ends, and which, consequently, as in Greece, has allowed these short lived Governments to run a career of reckless folly, indifferent alike to the support and the feelings of the masses of the people [2]

In the thirties, the tide of British investment turned in the direction of the United States. The bill drawn on London had assumed

[1] Halévy, *A History of the English People in 1815*.
[2] H. H. Parish, *Diplomatic History of the Monarchy of Greece*.

an important position in the finance of American trade. The American trade in tea and silk with the Far East, for instance, was settled by these bills, which then went from Hong Kong to India in payment for opium, and finally reached London in payment for exports of manufactured goods to the East, or as part of the Indian revenue. In the thirties there was a boom in Anglo-American investment through the floating of loans by states and municipalities for the development of public works. The immediate success of the State-constructed Erie Canal caused a boom in similar enterprises which were financed mainly by British capital. Although the investor knew little about American State finance, the high rate of interest, combined with the fact that the capital was supposed to be employed "productively" attracted large sums of money. Finally, an excessive development of the system of credit caused a collapse in America followed by a suspension of interest payments and, in certain cases, by repudiation of debts.

The disappointments of the early forties—for at one time £50,000,000 in Government stocks were in default—caused an increase in home investment and gave rise to the railway boom of the forties. The money market during this period extended the scope of its appeal to a large investing public, composed mainly of middle classes. Financial information began to be widely disseminated when the leading London and provincial newspapers commenced the publication of a regular money article. This article dealt with trade, the exchanges, and other topics having a bearing upon the markets for short-term loans or long-term investment. The first financial paper for the general public was the *Mining Journal*, founded in 1834. This dealt with mining companies in which British capital was employed, but carried news of other companies as well. The development of railways at home soon led to activity in overseas railway building, thereby opening up a new and vast field for the investment of capital The British investor advanced large sums to Governments for the purpose of State railway construction, whilst in other cases companies were formed with British capital to construct railways in undeveloped countries, such as Canada or the Argentine Republic. These Government and railway securities were widely quoted and dealt in on the London Stock Exchange, so that there were developments in the machinery

for dealing in securities. This railway development had a further important reaction upon the organization of the money market, since it was followed by "the development, extension, and specialization of the mechanism of credit for facilitating the new world movement of goods. Banking, exchange businesses, discount and accepting houses, produce exchanges and speculative markets all expanded and altered in character. The development of credit in all its various forms became very elaborate to enable these intricate world operations to be carried out smoothly "[1]

In the fifties and sixties the mercantile credit mechanism of the London Money Market extended its ramifications abroad. The bill-broking firms had become the most powerful financial institutions of the City. In 1855 a big step forward in the financial organization of business occurred, when the principle of limited liability was adopted in the Companies Act of that year This measure, together with the consolidating Act of 1862, made possible the attraction of much more capital into industry, since persons could now invest in industrial and commercial enterprises without any risk of losing, at the worst, more than the amount of their original investment. After the introduction of the new legislation, all partnerships with seven members might register as companies with limited liability. Banks were at first excluded, but in 1858 they were included in the concession unless they issued notes This change in the law offered a considerable stimulus to company promotion, and between 1862 and 1870 more than six thousand companies were registered. It also caused a new development of financial organization since, hitherto, British financial institutions had held aloof from anything in the nature of permanent investment in business. Now there arose a series of finance companies having as their object the development of all kinds of productive undertakings. Their mode of operation was, in the majority of cases, quite unsound, involving as it did the acceptance of money on deposit, repayable at short term, and the advancing of these funds in permanent investments, often of a speculative character. Into this class of business many banks and discount houses of established reputation were tempted with disastrous results. In May, 1866, the City was shaken by the

[1] L. C A. Knowles, *The Industrial and Commercial Revolutions in Great Britain during the Nineteenth Century.*

failure of a number of these companies, but the crowning disaster was the failure of the firm of Overend, Gurney & Co , whose reputation ranked second only to that of the Bank of England. In the crisis which followed, these unsound institutions were swept out of existence.

In the last thirty years of the century other financial centres came into being, but no other money market challenged the position of London as the great market for commercial bills and accommodation paper. Thanks to the existence of well-established discount houses and bill brokers, the London Money Market provided unrivalled facilities for the finance of trade. The sterling bill had come to be regarded as the international currency of commerce, and it could be said that Great Britain "has provided all the financial facilities needed for its exporters and importers to do business with other men anywhere on the globe, and conversely through British agencies, merchants in the most remote regions have been able to transact business, not only with British subjects but with the merchants of any other country."[1] Over and above this function of acting as a great centre for the finance of trading activities, the London Money Market advanced large loans to other countries by way of long-term investment. London was a free capital market, unlike Paris and Berlin, where the respective Governments exerted control over foreign loans. The greatest power in London lay in the hands of the Stock Exchange, which had adopted the practice of refusing quotations of the securities of Governments which had, in the past, failed to fulfil their obligations.

There exists but little agreement on the rate of growth of British overseas investment. In the course of the upward movement of trade, which occurred between 1869 and 1873, there was a flow of British capital abroad, mainly to the United States. It has been estimated that by 1875 the total of British foreign investments was not less than £1,200,000,000, and that by 1914 the figure had increased to £4,000,000,000. Although such estimates are necessarily subject to a wide margin of error, there undoubtedly occurred in the seventies a big investment of British capital overseas, and this movement continued with temporary set-backs up to the outbreak of war. This growth of investment caused considerable

[1] U S.A. Federal Trade Commission.

changes in the national policy and outlook Early Victorian statesmen had insisted that it was no part of their duty to look after the interests of British investors in foreign countries, but the developments of the seventies created a new attitude—

> Where loans were made directly to foreign Governments there was a growing tendency to insist on political and economic safeguards, concessions, and liens on local revenues. Moreover, as trade changed its character and came to include a growing amount of capital goods paid for by loans from British citizens to foreign companies or sold to British companies operating abroad, the British people came to have a far more direct interest in the political and economic behaviour of the countries to which they sent their savings . . . the seller of factory plant or a railway to an undeveloped country could only hope to be paid back by instalments, as the capital goods he sold became productive over a period of time He had, therefore, a strong interest in their being used to the best economic advantage, and was inclined to regard the preservation of order and tranquillity in the countries to which he lent his money as one of the rights of property.[1]

ORGANIZATION OF THE MONEY MARKET. We have already, in a previous chapter,[2] given a statement of the general types of financial institutions which we may expect to find in a developed financial centre We have now to examine the form which these institutions assume in the London Money Market which has long been recognized as the most comprehensive and highly organized in the world. Indeed, it may be said that London is the only centre in the world where the supply of and demand for money are efficiently organized and controlled. Strictly speaking, the London Money Market is not a single market at all, but a group of markets, for it embraces the discount, acceptance, bullion, and foreign exchange markets, as well as the markets for new capital and for issued securities. The central institution of the market is the Bank of England, whilst the most prominent members are the great clearing banks. We have already discussed the nature of these organizations in some detail, and it now remains to consider briefly the nature of the other components of the market.

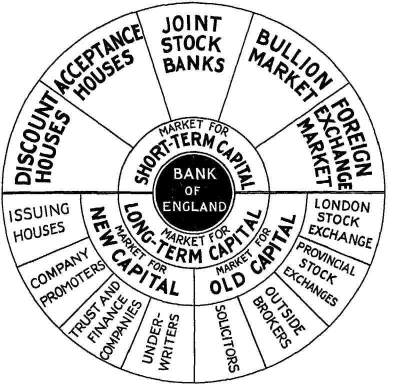
Accepting Houses. In pre-war days the acceptance business was carried on mainly by private banking firms which had evolved out of merchant firms engaged in foreign trade. The business has, since the War, been subject to keen rivalry on the part of the joint-stock

[1] G D H. Cole, *British Trade and Industry*.
[2] Chapter V, p 123

banks, though the operations of the latter are still confined mainly to first-class and the less specialized types of business. The acceptance market, through the expert knowledge of the dealers comprising it, is able to transact with safety much commercial business which the banks themselves would not care to touch. The business of these houses is to accept bills which are drawn on them by traders instead of drawing on the true debtor. For example, a British importer wishing to import goods from South America, will go to an accepting house and ask them to open a credit in favour of his supplier through a South American bank The overseas exporter, after shipping the goods, draws a bill for their value on the London accepting house and sends it to the local bank to be discounted. He forwards the shipping documents with the bill, and the bank, relying on the standing of the accepting house which has furnished the letter of credit, discounts the draft, so that the South American exporter receives his money at once. The bank then forwards the draft and shipping documents to its London agent for presentment to the accepting house. Once accepted, the London agent may hold the bill till maturity or discount it at once and reimburse his principal in South America. The shipping documents may be retained by the accepting house until the account is settled by the British importer, or, as is more usual, handed over to him at once. The accepting house draws a commission for its services in the transaction.

In the above example, we have considered a case where one of the parties to the transaction is located in this country. In a very large number of cases, however, the goods do not touch this country at all, but are financed by bills drawn on London A merchant in France, who is a client of a London accepting house, wishes to purchase goods in Chile The South American merchant has probably no knowledge of the credit standing of the Frenchman, but neither he nor his banker has any doubt as to the standing of the London acceptance house. The French merchant makes arrangements with the acceptance house to accept a bill on his behalf, and instructs the seller of the goods in Chile to draw a bill on the acceptance house for the amount of the consignment In all probability the Chilean merchant will hand the bill, with shipping documents attached, to his banker. It is discounted by the latter, and is then forwarded to London for acceptance. The acceptance house may

THE MONEY MARKET AND ITS ORGANIZATION



The London Money Market may be divided into two principal sub-divisions—the market for short-term capital and the market for long-term capital. The former includes the activities of the joint-stock banks and the merchant banking institutions which deal in bills The market for long-term capital is divided into the section which deals with new issues and that concerned with transactions in securities which are in the hands of the investing public, but where a change in ownership is desired. The market for such old securities is furnished by the Stock Exchange.

forward the shipping documents immediately to the French merchant so that he may take delivery of the goods, or may retain them until cash has been received from him to the amount of the bill. In effect, then, the credit of the acceptance house is interposed between the seller and the buyer, thus providing a basis of confidence upon which a trading transaction can take place.

The complaint is sometimes made that this system provides foreign traders with cheap acceptance facilities at the expense of British exporters. Although no reliable figures exist, it is known that the predominant part of bankers' acceptances in the London Money Market is used in financing the trade of foreign countries, but this, of course, must naturally be the case if London wishes to retain her position as an international banking centre. Furthermore, British exporting houses of good standing can employ the facilities offered on exactly the same terms. It is said, however, that first-class British business houses do not care to have their bills in circulation and prefer to obtain credit through the more expensive bank loans. To this extent, therefore, the remedy lies in their own hands. Yet, it would be wrong to assume that it is the resources of London alone which are being employed to finance a large part of the world's trade. The great majority of the foreign customers for whom the acceptance houses accept bills, hold large deposits of funds with the acceptance houses. These funds are equal to the bills which are drawn upon the acceptance houses, so that London is not required to produce any money.

As mentioned above, the acceptance business has been undertaken, to a certain extent, by the joint-stock banks since the War, though the bulk of their business is thought to be with foreign banks. The banks conduct the business as a single department of their activities, whereas the acceptance houses specialize upon it. In consequence, they are able to undertake business which carries with it a heavier burden of risk—a course of action in which they are justified because of their special knowledge of the business which they are doing.

Discount Houses. This market carries the work of the accepting houses a stage farther by providing means for maintaining an adequate supply of liquid funds. The business is mainly concerned with the buying and selling of bills drawn on the accepting houses,

and as the rate charged for discounting such bills is lower than that charged on bills drawn on commercial houses, the commission charged by the accepting houses for guaranteeing payment is usually more than counterbalanced by the differences in the rates charged for discounting the two types of bill The capital of the discount market is invested mainly in securities, which are used as a guarantee for the loans granted by the banks and others in order to provide the funds necessary for its work.

The London discount market consists of three public companies, which control about one-half of the total capital invested in the business, and also of a number of private companies and firms. The bulk of the resources employed by the market are obtained by direct borrowing from the banks for which the market acts as a second line of defence. In order to meet the demands which are made upon them by their customers, the joint-stock banks maintain cash reserves at their branches, whilst their balances held at the Bank of England are regarded as cash since they are withdrawable on demand. The banks require, in addition, a means whereby their surplus resources may be invested remuneratively, and yet, at the same time, be easily liquidated. Herein lies the function of the discount market which receives money for short periods—as a rule, from one to seven days.

The principal source of supply of bills is furnished by the accepting houses, whilst large quantities come from the foreign and colonial banks, either direct or through a "running" broker. The functions of this latter intermediary are becoming more and more restricted with the passage of time. The broker does not assume liability for any of the bills in which he deals, but makes his profit by a small commission. The market divides the bills which are supplied into two categories—Bank Bills and Fine Trade Bills. The former are bills accepted by British banking institutions, including accepting houses, whilst the latter are drawn and accepted by first-class merchants and traders. These bills are discounted at Market Rate which is lower than the Bank Rate. Two quotations are usually given for the market rate, the lower of which is applied to bank bills and the higher to trade bills, so that the buyer of the latter obtains a larger allowance in interest to compensate him for the greater risk which he runs.

Bullion Market. The British Empire produces about 70 per cent of the world's output of gold, so that, in consequence, London has become the principal gold market The most important source of open market supplies of gold are the consignments from South Africa, which are offered in the market every Tuesday and sold to the highest bidders. The destination of these purchases is watched with keen interest, although it may happen that the identity of the purchaser is not revealed. It may be possible to deduce this information later on, as, for example, if the daily announcement of gold movements, issued by the Bank of England, shows a purchase of gold coinciding with the amount sold in the open market. Again, it may be possible to obtain the information from figures relating to the import and export of gold published twice weekly by the Customs.

Three factors have recently combined to affect the position of the London gold market, namely, the practice of direct shipments of South African gold, forward buying of South African gold, and the establishment of an international gold clearing system by the Bank for International Settlements.[1] Thus, the gold requirements of India have been met by direct shipment from Durban, thereby saving transport costs. Again, a part, or sometimes the whole, of the bar gold shipped from South Africa has been sold while in transit to this country. This has occurred in the case of France, when, as a result of the depreciation of sterling in relation to the franc, a better price could be realized owing to the premium commanded by forward French exchange. Hence, when forward buying occurs, the bullion is no longer available when it reaches the London market.

Foreign Exchange Market. The organization of this market enables the debts of traders in one country to be settled by the debts of traders in another. The basis of these operations is, as already pointed out, the bill of exchange, but in recent years, as a result of the centralization of the foreign exchange business in the hands of the great London banks, international debts are now usually settled by cable remittances, because of the speed, convenience, and safety of this type of settlement. In addition to the foreign exchange

[1] See *Economic Journal*, March, 1931. "Recent Changes in the London Gold Market," by Dr Paul Einzig.

departments of the banks, there are in London about forty foreign exchange brokers who specialize in different currencies The brokers are in constant telephonic and telegraphic communication with the banks in this country and with their correspondents overseas. They act merely in the capacity of intermediaries on behalf of their customers, the banks

Formerly, the London foreign exchange market was located in the Royal Exchange, but at the end of 1920, meetings were discontinued, and now the market has no central meeting place. Indeed, at the present day, the market is nothing more than a close network of telephones, which connect up dealers and brokers both in London and in the provinces, as well as the nearer Continental centres. There is no formal membership of the exchange market such as found in the case of the Stock Exchange, although, in practice, the bulk of the dealing is done by the joint-stock banks and the larger banking houses These institutions undertake exchange transactions for clients who bring them other business, and, in consequence, the banks quote low rates, which make the position of the pure foreign exchange dealer somewhat difficult. The dealers receive orders from the general public and carry out the transaction through the mediation of a broker. The broker does not deal himself, so that one of his principal functions is that of linking up existing supply and demand In addition, however, he performs a further service of considerable importance, namely, that of acting as arbiter with regard to the rate agreed upon for each deal—a formality which is settled even before the names of the two parties to the contract are declared to each other.

Market for Long-term Capital. Hitherto we have considered the various institutions of the market which are concerned with the supply of short-term capital. Taking a wider view of the market, however, we may also include institutions which deal in the permanent capital invested in industry and commerce. This market consists of two sections, each of which is distinct in function. The first section consists of the *market for new capital*, which comprises those institutions which prepare and offer new securities to those seeking opportunities for investment. In England, this market for new securities is made up of a vague, ill-organized, group of institutions which collectively perform the work of issue.

The more important of these are the underwriters, among whom are included many of the banks, the Trust and Finance companies, Insurance companies, and financiers of all descriptions, the brokers who lend their names to the prospectuses, assign the underwriting on payment of an "overriding" commission, carry through many of the technical formalities, and open up a market among their clients, the bankers who receive subscriptions from the public and issue securities in exchange; and the advertisement houses whose specialized machinery may enable them in some cases to distribute a million prospectuses in a day among a selected public, together with the experts who draft an attractive prospectus and arrange for advertisement and notices in that part of the financial and general Press which is appropriate to the particular issue.[1]

The second section of this organization is the *market for old securities*, which acts as a natural complement to the business of issuing new securities. This market consists of the highly-organized London and provincial stock exchanges through the medium of which ownership rights in already existing securities may be transferred from one person to another The existence of this market facilitates the work of issuing new capital, since the investor subscribes to new issues with greater confidence when he knows that there exists machinery which will enable him to liquidate his investment in case of need.

BANK OF ENGLAND AND THE MONEY MARKET. The Bank of England, acting in its capacity as a central bank, is charged with the duty of maintaining the stability and integrity of the monetary system. In order to discharge this responsibility, it is essential that the Bank should be in a position to exercise control over the credit created by other institutions of the money market, so that the Bank must act as the leading concern in the market. It must have weapons at its disposal whereby it can make its policy effective The degree of influence which it can exert upon the various members of the market is, of course, by no means uniform, some being affected quickly and directly, whilst others are influenced only in a more indirect manner.

The immediate influence of the Bank's policy is felt in the market for short-term capital and, in particular, by the discount market and the joint-stock banks. The discount market operates, first of all, with its own capital, and secondly, with funds borrowed from the commercial banks on day-to-day loans. These loans may be

[1] Lavington, *The English Capital Market*.

withdrawn from the market at any time when a bank wishes to strengthen its cash position Hence, a bill broker who is carrying bills of exchange with that money, necessarily has to replace it by borrowing elsewhere. Should all the banks call in, simultaneously, their loans to the discount market, then there is only one place to which the brokers can go to borrow funds in any quantity, and that is to the Bank of England By taking bills of exchange of a specified type to the Bank, the bill broker can borrow funds by discounting them with the Bank at the official rate of discount, known as the *Bank Rate.* It is an understood thing that the discount market can always obtain accommodation from the Bank within certain limits and on certain terms The Bank must, of course, impose certain restrictions from time to time in order to safeguard its own interests. For example, suppose that the market considers that the Bank Rate is likely to rise in the near future so that there are expectations of a period of high rates, the brokers may decide to discount their holdings of bills immediately at the Bank, and replenish their portfolios at the higher rate. In such circumstances, the Bank may decide to grant all the accommodation which is required, but will discount bills only with a short period to run—say, two or three weeks.

Again, the Bank will discount bills only of a certain approved type, and although no regulations are imposed by statute in regard to this matter, the custom is quite definite. The bills must bear at least two good British names, one of which must be the acceptor. The bills may represent the movement of commodities from abroad to this country, or they may relate to transactions in which this country is not concerned at all, except that they are financed on the basis of credit obtained from a British acceptance house. In such a case, although the bill relates to movements of goods abroad, it is a British acceptance. By offering such instruments for discount, the market knows that it can always get accommodation at a price. It should not, however, be inferred that any discount house can come to the Bank and obtain accommodation without limit, but the relations between the Bank and the discount market are of an extremely intimate nature. In view of the service which the Bank renders to the market, it claims the right to be kept fully informed regarding the position of the discount houses, and may even require to see their balance sheets.

The relationship between the Bank of England and the joint-stock clearing banks is of an intimate character, being fundamentally that of banker and customer. The Bank issues currency and receives it, according as the clearing banks choose to demand or to pay in cash. It also acts as the agent for the Clearing House in the settlement of clearing differences between one bank and another by means of book entries. The joint-stock banks regard their balances at the Bank of England as cash holdings, and these, combined with their till money, furnish the sums required to meet the ordinary operations of the day between themselves and their clients. In the ordinary course of things, the Bank has no means of knowing, with any degree of accuracy, what cash reserves the joint-stock banks hold by way of till money. On two occasions during the year—the 30th June and 31st December, when the banks make up their balance sheets—the Bank is able to arrive at an accurate figure with regard to the volume of cash held as till money. The monthly statements which are produced by the clearing banks are of little value since they are historical in nature when they appear, and offer no means of keeping touch with fluctuations in cash reserves as they occur. The monthly figures supplied by the banks are subject to a further grave defect. There are four different days of the week on which the banks compile their statements as to cash reserves, and each bank, on its make-up day, strengthens its cash position at the expense of the remaining banks and other members of the money market. As Mr. Keynes puts it—

> Each takes it in turn to call from the money market a certain quantity of resources which will swell their balance at the Bank of England on the day of the week sacred to the particular bank which is calling. In this way a certain part of the published reserves of the "Big Five" is a stage army which appears four times over. When Bank A's sacred day has passed, it lends to the money market that part of its Bank of England balance which is no longer required for publication purposes, for the money market to pass on as promptly as possible to Bank B whose sacred day has arrived, so that a Bank of England balance which belonged to Bank A's reserve at dawn has put in a public appearance before sunset as part of Bank B's; and so on, day by day.[1]

This uncertainty, however, obviously extends to the balances of cash on hand as well as to Bank of England reserves, and, consequently, imposes difficulties in the control of the currency. If there

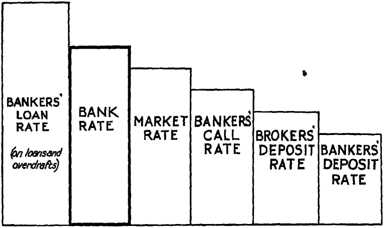
[1] *A Treatise on Money* (Vol. II)

is a demand by the public for an increased currency circulation, to the extent to which that increased demand may be met by the bankers out of their reserves, there is no indication to the Bank or to the public that an increased demand for internal circulation has taken place. In like manner, if notes are returned from circulation, and are used to add to the banker's internal cash reserves, the fact is not indicated.

The connection between the Bank and the various institutions in the market for long-term capital is of a more indirect character. The Bank, through its discount policy, may exert an influence on Stock Exchange dealing, and on the amount of speculation The relations of the Bank with the issuing houses which undertake the issue of the higher-class securities, are quite informal in character. These institutions usually inform the Bank of their intentions when they are about to make a new issue in order to avoid the danger of placing too many issues of a particular kind upon the market at one and the same time A certain amount of restraint may be exercised to prevent any interference with Government operations. The whole relationship is, however, quite informal, and is carried on in the interests of both parties.

BANK RATE POLICY. There are two general methods whereby the Bank of England controls the volume and terms of credit in the domestic monetary system in order to maintain the stability of the national monetary unit. The first of these is usually described as the Bank Rate Policy, that is to say, the terms upon which the Bank is prepared to purchase approved bills from the market. The second method comprises what are known as open market operations, that is, the purchase or sale of assets in the market, on the initiative of the Bank of England itself. As we have already seen, the Bank Rate is the rate at which the Bank of England is prepared to discount first-class bills of exchange. Much of its influence is due to the fact that, by custom, the clearing banks vary certain rates of interest, charged or allowed, by reference to the level of the Bank Rate Thus, the rate of interest allowed by the clearing banks on London deposits—known as the banker's deposit rate—is usually 2 per cent below Bank Rate. The rates charged by the banks on loans and overdrafts, as well as on advances of call money to the discount market, usually bear a more or less fixed

DIAGRAM SHOWING RELATION BETWEEN THE RATES OF INTEREST IN THE MONEY MARKET



Bankers' Loan Rate. The rate of interest charged by the joint-stock banks on loans and overdrafts It is usually fixed ½ per cent to 1 per cent above Bank Rate, with an agreed minimum of commonly 4 per cent to 5 per cent.

Bank Rate. The official minimum rate of discount at which the Bank will discount certain types of bills for the discount market. The Bank may discount bills at a slightly lower rate for private customers.

Market Rate. The rate charged by dealers for discounting first-class bills of exchange. A number of different rates are usually quoted according to the tenor of the bill, e g 60 days', three months' bills, etc.

Bankers' Call Rate. The rate of interest charged by the clearing banks on call money to the discount market. The rate is usually fixed at a higher level than the bankers' deposit rate.

Brokers' Deposit Rate. The rate paid by the discount houses on deposits received from the public. Interest is usually paid at ¼ per cent to ½ per cent above the rates paid on deposits by the banks.

Bankers' Deposit Rate. The rate of interest allowed by the clearing banks on London deposits, repayable at short notice. It is usually fixed at about 2 per cent below Bank Rate.

relationship to the Bank Rate. Again, the Bank Rate is normally fixed at a level relatively to the open-market rate of discount for bills, which makes it unprofitable for holders to re-discount them at the Bank. In consequence of this connection between the different rates of interest, changes in the Bank Rate cause movements in the rates both for short money and Bank loans.

Under a gold standard system, the aim of the Bank Rate policy is to maintain a credit position which will offer a reasonable assurance of the convertibility of the currency into gold and, within the limits thus imposed, to adjust the price and volume of credit to the requirements of industry and trade. The rate is determined after very careful consideration of existing circumstances, chief of which are the state of the Bank's reserves, the condition of the money market, both as regards rates and also as regards the volume and character of the funds, domestic and foreign, in the market, and finally, the position and trend of the foreign exchanges. Indeed, on account of the important position which London holds in world finance, although the internal effects on British industry and commerce are given due weight in fixing the level of the Bank Rate, international considerations are usually predominant. Although, so far as the legislative position is concerned, the Bank is a free agent, capable of determining its own policy, London forms part of an international financial system which is, normally, bound together by the link of the gold standard. This being the case, the Bank is not, from an economic standpoint, a free agent, but is compelled to order its policy in accordance with events which are occurring elsewhere. Under an international gold standard, the freedom of the Bank of England to pursue an independent policy is necessarily restricted, so that it must pay due regard to the course of action of other central banks. It has been pointed out that—

> According to traditional theory, this bond between the monetary policies of countries on the gold standard is established in two ways: partly through the interdependence of discount rates and the flow of international short-term investment; and partly through price levels and the flow of international trade. Thus, to consider the first of these, the theory shows that it would be impossible for the Bank of England to maintain its Rate continuously out of adjustment with those of important foreign centres For if, at any time, the Bank Rate in London is fixed substantially lower than foreign rates, short-term investment leaves London in search of more profitable return abroad. Sterling bills

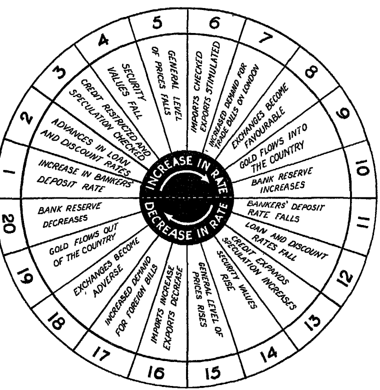
and sterling balances seek exchange into foreign currency, and the foreign currency rises in value. When the rise has gone beyond a certain point, it becomes profitable for bullion dealers to buy gold with sterling at the Bank of England's fixed prices, export the gold for exchange into foreign currency at the foreign bank's fixed price, then, with the high-value currency, buy more cheap sterling, and repeat the process. The movement cannot proceed far without serious threat to the gold reserves of the Bank of England; and the Bank's only remedy in the long run is to reverse the initial cause, by raising its Rate and bringing it again into line with rates abroad.[1]

In pre-war days, the policy which was being pursued by the Bank of England was frequently followed by other centres, that is to say, if the Bank Rate were reduced, it probably brought about a corresponding reduction in the rates in other financial centres. At the present time, although London still possesses a certain amount of power to give a lead to other countries, this influence is by no means as strong as it used to be. The leadership of London has been affected considerably by the strong position of New York since the War. This was clearly seen in the course of the Wall Street stock market boom in 1929, when interest rates in America undoubtedly had a powerful effect both upon rates in London and elsewhere In an attempt to check the course of the speculative boom, the Federal Reserve authorities forced up the rates of interest for call loans The effect was to attract a large volume of short-term funds from the money markets of Europe, and to create great pressure on the foreign exchanges. In consequence, there occurred a period of steadily-rising bank rates, each central bank in turn attempting to protect itself against a loss of gold to its neighbours. In such circumstances it was futile to expect London to adopt an attitude of independence and frame her policy apart from any consideration of the international position.

Let us now trace out the cycle of consequences which normally follow an increase in the Bank Rate under a gold standard system. The immediate effect is to cause an increase in the bankers' deposit and loan rates. The price which the bankers are prepared to pay on sums left with them by their customers on deposit account increases, so that the tendency will be for the volume of bank deposits to increase. But, as we have seen, the joint-stock banks

[1] Memorandum of Evidence submitted by Prof J R. Bellerby to the Committee on Finance and Industry, *Minutes of Evidence*, Vol I.

CHANGES IN THE BANK RATE AND THEIR EFFECTS



Under a gold standard system, the Bank Rate is used as an instrument of policy to maintain the stability of the national monetary system by safeguarding the gold reserve in the hands of the central bank. Its efficiency depends in a great measure upon sympathetic movements which occur in other interest rates, so that an increase in the Bank Rate has the effect of tightening up market rates, checking business enterprise and speculation. It sets in train a sequence of events which ultimately cause a favourable reaction of the exchanges and an inflow of gold. A decrease in the Bank Rate tends to have the reverse effects. Since the War, the Bank Rate has frequently proved ineffective to bring about these results and has had to be supplemented by "open market" operations.

employ a substantial proportion of the funds deposited with them to form the basis of loans to other customers, and, inasmuch as the banks are now paying more for these deposits, they must charge more for loans and advances made to their customers. Many business operations are conducted on the basis of bank loans, and the price which has to be paid for this accommodation is, of course, a charge against the profits of the business. In consequence, a sudden increase in interest charges may seriously diminish, or even wipe out, the profits of a business so that industrial and commercial borrowers begin to reduce the sums which they borrow. In order to find money to pay off the loans, many business houses are compelled to restrict their credit to customers. There is, in consequence, a general restriction of credit, while the volume of bank loans and advances is considerably curtailed.

Again, a great deal of business on the stock exchanges is conducted with the aid of bank loans. An increase in the rate at which these loans can be obtained may make it difficult or impossible for dealers to earn a sufficient margin of profit, so that they tend to liquidate their holdings of stocks, thereby causing a downward movement of security prices. A somewhat similar movement takes place in the commodity markets, where manufacturers and merchants hold large stocks on credit against Bank loans. Attempts are now made to sell these at the earliest possible moment, and, as a result, the market develops weakness, and commodity prices fall The drop in prices causes England to become a good market for the foreigner to buy in but a poor one to sell in, with the result that commodity imports are checked but exports tend to expand. Foreign importers will be desirous of making payment for the goods that they have received, and will demand bills on London for this purpose. This increase in demand for London trade bills will tend to cause an appreciation of their value so that the value of sterling in relation to other currencies will rise—in other words, the exchanges will move in our favour. This tendency will be accentuated by the fact that, in all probability, there will be a movement of short-term funds to this country with the object of taking advantage of the higher rates of interest prevailing in London. The cumulative effect may be so great as to cause the value of sterling to increase so as to make it cheaper to pay by sending gold bullion instead of paying by a

bill of exchange. A movement of gold may therefore take place and strengthen the reserves of the Bank of England. In view of the stronger position, the Bank may feel justified in lowering the Bank Rate and thereby check gold movements.

The Bank Rate policy is supplemented by what is known as the "open market" policy of the Bank. As was pointed out by the Committee on Finance and Industry, these open market operations may assume the following forms—

1. Measures which, after taking account of the changes, if any, in the Bank's gold reserves and in the Public Deposits, have the effect of changing the aggregate amount of the Bank's Private Deposits.

2. Measures which consist in changing the form of the Bank's assets without changing their quantity. Thus, the Bank may offset movements of gold by buying or selling securities; it may sell short-dated securities, such as Treasury Bills, and at the same time buy long-dated securities, such as Consols, finally, the Bank may compel the market to discount or obtain advances on the official terms, with the object of bringing market rates into closer conformity with Bank Rate, by selling securities.

The relative importance of these different methods is entirely dependent upon the circumstances in which they have to be applied. What might be the most suitable means at one time might be less suitable at another time. The control of credit by the sale of investments is a method which has been greatly developed since the War, and has been described by Mr. J. M. Keynes as an ideal method of control.

> It enables the Bank of England to maintain an absolute control over the creation of credit by the Member Banks—to a degree such as exists in no other monetary system. The Bank of England has evolved the perfect method of transferring to the Central Authority the complete control of the members of the banking system of the country. It is not an exaggeration to say that the individual Member Banks have virtually no power to influence the aggregate volume of bank-money—unless they depart from their reserve ratio conventions, and even then, the old position is restored if the Bank of England sells investments to a corresponding amount [1]

The greatest difficulty which lies in the way of the most effective operation of the open market policy is the lack of detailed knowledge

[1] *A Treatise on Money* (Vol. II)

at the disposal of the Bank with regard to the cash reserves maintained by the clearing banks. If it appears to the Bank that there is an excessive volume of funds seeking employment in the short-loan market, so that market rates are weakened and the Bank Rate policy is ineffective, then the Bank will take measures to curtail credit by selling bills. In this way the surplus funds are absorbed and the market rates tend to rise. The difficulty arises from the fact that the Bank cannot always be certain whether this glut of short-term money is a passing phenomenon, or whether it is of a more permanent nature If the position is likely to last, it will probably be desirable to curtail credit, but if it is merely a temporary phase, then credit restriction may be undesirable in the extreme There is scope for closer collaboration between the joint-stock banks and the Bank of England in regard to such matters.

CRITICISMS OF BANK RATE POLICY. The Committee on Finance and Industry, whilst admitting the necessity of the Bank Rate as a method for managing the monetary system, advanced a number of criticisms against the manner of its employment. In the first place, difficulty and uncertainty arise on account of the traditional attitude of secrecy of the Bank of England. The business community has always found it difficult to interpret the meaning of a change of Bank Rate in any particular instance An alteration may have been made merely for the purpose of correcting a temporary maladjustment, or it may foreshadow a long-period adjustment. The use of the Bank Rate has powerful psychological effects, and, in the absence of any statement from the central bank with regard to its motives, a minor change of a temporary nature may cause unwarranted apprehension among business men and seriously disturb their activities. It is, of course, recognized that there are very serious objections to the circulation of advance information of a pending change in Bank Rate policy. There are so many people who are in a position to profit by an advance knowledge of the action to be taken, that to attempt to give widespread publicity would do more harm than good. It is better to maintain secrecy until such time as a proper announcement can be made. None the less, there should be a possibility of a greater diffusion of information by the Bank of England, particularly to the money market. As the Committee pointed out: "there is still a degree of

aloofness and remoteness in the daily relations between the Bank of England and the clearing banks which does not exist, for example, between the Bank of England and the merchant banks, the leading issuing and acceptance houses, and the bill-brokers." A greater degree of co-operation would make the Bank's policy more effective, and might go far towards avoiding any unnecessary disturbances to confidence.

Under a gold standard system, Bank Rate policy has tended to be associated closely with movements of gold. A shipment of gold from London to New York tends to raise the Bank Rate in London and to lower it in New York. These movements of gold actually take place before there is any change in the policy of the central bank, since an alteration in gold reserves is one of the indications that there is need for adjustment. Yet a policy determined in this way may be too slow, for movements of gold are often the last event in a situation which has been developing for a considerable time. Hence, there is a case for arguing that the Bank should take steps to secure more complete knowledge of what is going on in our economic system, and so create a possibility of taking action at an earlier stage, to correct aberrations before they have gone too far in order to ensure greater stability of business. Action of this nature, designed to apply corrective influence before difficulties fully develop, would place a heavy responsibility upon central banking authorities. Moreover, action taken upon information which is possibly of a confidential nature, would be extremely liable to misinterpretation by the business world.

The Bank will not, of course, base its policy exclusively on movements of gold in and out of its reserves when working on a gold standard, but it must take into account other aspects of the country's economic position, both in the present and in the immediate future. Thus, after the resumption of the gold standard in 1925, the Bank was frequently charged with not allowing the inflow of gold to have its normal effect on credit. Such an action is usually prompted by the fact that the Bank knows that a reverse movement is likely in the near future, and wishes to have the means to withstand it when it comes without having to curtail the volume of credit. In the early months of 1928, for example, considerable additions were received to the gold stocks of the Bank, but no expansion of credit

took place. The Bank Rate stood at 4½ per cent and, had more credit been created, it would almost inevitably have forced a reduction of this rate. Such a reduction would, in all probability, not have been passed on to industry, since the joint-stock banks rarely lend money at a rate much less than 4½ per cent. Moreover, it was anticipated that the exchanges would move against this country later on in the year. This movement did, in fact, take place, and a heavy loss of gold followed. In spite of this, Bank Rate was maintained at the former level, whilst gold movements were not allowed to affect the volume of credit.

Nevertheless, although the system has not been operated in a blindly automatic manner, there are limits to the latitude which the Bank can allow under a gold standard. Bank Rate policy, based on gold movements, tends to maintain the stability of the exchanges rather than the stability of business. According to the Committee on Finance and Industry—

> It is a means of keeping us in step with the rest of the world, of keeping us, not at a steady pace, but at the same pace as others Indeed, so far from preserving a stability of prices, profits, and employment, the maintenance of stable exchanges has the effect of transmitting to our credit system any serious disturbances, of a cyclical character or otherwise, which may be affecting the rest of the world.

This, of course, is one of the penalties attached to the operation of an international monetary system, and the worst consequences can be obviated only by international action. It has been suggested that the effects of credit contraction initiated by the policy of the Bank have been much more severe because industrialists have borrowed much more heavily from bankers than is desirable. In other words, they have obtained too large a proportion of their credit in the form of bank credit instead of investment credit.

Although the Bank Rate may be applied to rectify a temporary disequilibrium, its use is attended by serious difficulty when more substantial changes have to be effected. If the general level of money incomes and prices is higher than is justified by the international position, and substantial changes in the level of industrial costs are necessary, alterations in the Bank Rate alone may be inadequate to cause readjustment. In a rigid economic system, the effects of the policy of a central bank are uncertain. A policy of "dear money" will restrict business enterprise, curtail profits, and

cause unemployment, so that pressure is brought to bear upon business men to reduce prices by curtailing manufacturing costs and wages. A drastic application of such a policy will create antagonistic public opinion, and will discriminate unfairly against certain sections of the community

THE TREASURY AND THE MONEY MARKET. The financial operations which the Government conducts through the Treasury are of the greatest importance to the money market at the present day. For example, income tax and sur-tax are collected largely during the first three months of the year, thereby causing a certain financial stringency. The process of payment of taxation produces a diminution in bankers' deposits which may find reflection in the volume of their loans as well. Close contact is maintained between the Bank of England and the Treasury. The Bank holds all the main Government accounts, the chief of which is the Exchequer Account through which pass all the main receipts and payments of the Government. The individual spending departments of the Government do not keep separate accounts at the Bank. They draw upon the Paymaster-General, who, as he requires funds, draws them from the Exchequer Account. The Bank undertakes the issue of all Government loans, manages the stocks, pays the dividends, and registers transfers. From time to time, the Bank is called upon to provide overdrafts to the Government—technically known as Bank of England Ways and Means Advances. Generally speaking, it is only on the 1st June and on the 1st December, when the War Loan dividend has to be paid, that these are of any consequence. Government balances are built up for a number of days before these dates, whilst any deficiency is usually supplied by the Bank and is paid off as quickly as possible.

The Bank also acts as the agent of the Government for the sale of Treasury Bills, which are issued weekly in the presence of a representative of the Treasury who determines the quantity of bills to be sold. The Treasury gives the Bank its views as to the probable income and expenditure in the near future, and, acting in the closest collaboration, the Bank endeavours to ensure that the ebb and flow of these movements in Treasury finance shall not cause any avoidable disturbance in the market conditions. The number of Treasury Bills has increased immensely since pre-war days Before the War,

the normal maximum of Treasury Bills outstanding was in the neighbourhood of £30,000,000, whilst the present total is roughly £600,000,000. It should be remembered, however, in considering this total, that a considerable portion of the fiduciary issue of the Bank of England is covered by Treasury Bills, so that £600,000,000 cannot be regarded as the active volume of bills Even making such allowances, however, the volume is much greater than it was. On the whole, the volume of commercial bills appears to be less, owing to a tendency to replace financing by bills by financing by overdrafts. This latter tendency does not appear to be altogether desirable, since an overdraft is not a very liquid asset, whereas a bill can be bought and sold at any moment.

This extension in the volume of Treasury Bills has increased the difficulties of the Bank in controlling the supply of credit. It has increased the dimensions of the bill market, thus making operations on a larger scale necessary in order to produce a given effect. Again, of all the bills in the market, Treasury Bills are the least responsive in many respects to movements in the Bank Rate. Treasury Bills have to be issued, no matter what the Bank Rate may be, and the only difference is to be found in the rate which the Government has to pay for the accommodation which it receives In pre-war days, the position was entirely different. A very large part of the bills which were then being carried in the market were on foreign account, and an increase in the Bank Rate had the effect of reducing their volume.

When the holdings of the market were mainly commercial bills drawn on London on foreign account, a rise in Bank Rate diminished the supply of these bills. Now that the market holdings are largely Treasury Bills and other Government "floaters," a restriction in the volume of bankers' cash, followed by a reduction of their market money, merely drives the "market" " into the Bank," i.e. forces the Bank of England to recreate the credit it has previously withdrawn—the discomfort traditionally associated with that lodging being largely mitigated by the fact that the general taxpayer bears a large part—sometimes more than the whole—of the expense in the form of a higher discount rate when the bills fall due for renewal.[1]

On this ground alone, therefore, there is much to be said in favour of a reduction in the volume of Treasury Bills. If this were

[1] *Report of the Committee on Finance and Industry*, Memorandum of Dissent by Lord Bradbury.

to take place, it would restore more efficiency to the Bank Rate, and bankers would be persuaded to endeavour to restore the use of commercial bills.

The seasonal fluctuation in the volume of Treasury Bills may also have a very disturbing effect upon the money market If, during February, the proceeds from the collection of income tax are applied by the Treasury to the reduction of the amount of bills outstanding, then, unless the Bank restricts credit, the demand for bills is likely to cause a serious weakening of bill rates. If no credit restriction takes place, the weakening of the bill rate may have disastrous effects on the foreign exchanges. On the other hand, if the Bank restricts credit, then the accommodation which is extended to traders is likely to suffer, despite the fact that in times of tax collection traders are ordinarily in need of assistance because they often have to borrow, to a certain extent, to meet the demands which are made upon them.

A large floating debt by way of Treasury Bills represents a source of anxiety to the Government and to the Bank The members of the money market who lend money to the Government on Treasury Bills, borrow it for short periods from the banks. They borrow at a rate which is a given degree below Bank Rate, and they lend to the Government at a rate higher than that at which they borrow, but at one which is below Bank Rate, for a period of thirteen weeks. It follows that if, during the currency of a Treasury Bill, the Bank Rate is increased, there will be a loss to the money market on the bills, because, for the balance of the currency of the bills, the members of the market will be borrowing from bankers and others at a rate higher than that which is accruing to them upon the bill If, therefore, the market anticipates an increase in the Bank Rate, it may show reluctance to tender for bills in large quantities. In such circumstances the Government must either borrow on Ways and Means Advances, or the Bank of England itself must take up the bills. Either process may create a difficult position which will itself force the threatened rise in the Bank Rate. This difficulty may, of course, arise, whether the volume of Treasury Bills be large or small, but there is always a minimum demand for bills, and the larger the excess over that minimum, the more difficult is the situation likely to become

On the other hand, at a time when there is perhaps a shortage of commercial bills, a reasonable amount of them provides a convenient medium for maintaining the efficient working of the money market and enabling the banks to preserve that degree of liquidity which they regard as essential.

ESSENTIALS OF AN INTERNATIONAL FINANCIAL CENTRE. There have existed in former days, as we have already seen, various important financial centres to which less fortunate countries have been compelled to resort when in need of financial accommodation. During the nineteenth century, and, indeed, right up to the time of the Great War, the importance of London was such as to render the work of other centres relatively insignificant. Since the War, however, London appears to have lost ground as compared with other centres, particularly New York and Paris, to such an extent that pessimists are not wanting to declare that her supremacy is a thing of the past, and that never again can she hope to regain her old position. In order to assess the truth of this contention, it is necessary to examine the conditions leading to the establishment of an important financial centre. Those of the past have invariably been great commercial centres for, despite the assertions of some who appear to think otherwise, the interests of trade and finance are inseparably connected. Moreover, the great financial centres of the past have enjoyed a favourable geographical location in relation to the areas which they have served—a fact which, of course, explains their development as commercial centres as well. In our own day the development of communications has tended to minimize the importance of geographical location, but even now the factor cannot by any means be ignored. Apart from other limitations, we cannot imagine Australia or New Zealand becoming international financial centres, on account of the fact that they are so remote from other points of intense economic activity.

Over and above these general considerations, weight must be given to a number of special factors which are more immediately connected with financial structure and organization. The most important of these have been enumerated by Dr. Paul Einzig as follows—

1. Ample capital resources available for lending abroad.
2. An adequate banking organization.

3. Freedom of the financial market.
4. An investing public willing to acquire and keep foreign securities.
5. A stable currency.
6. A good money market.
7. A good foreign exchange market.[1]

A financial centre cannot hope to attain to a position of international importance unless it has ample funds available for advancing to approved customers. The basis of these funds must be provided from its own internal resources—it was not until British industry and trade caused a great accumulation of capital in this country that London emerged as an international financial centre. The surplus for lending may arise as the result of a margin of exports of goods and services over imports, or in the form of income from existing foreign investments Yet, just as an ordinary banker makes but an insignificant proportion of his advances on the security of his own capital, so an important monetary centre does not rely exclusively upon its own internal resources for the conduct of its lending operations. It will be possible to attract funds for investment from other centres, and these can be lent out again to the profit of the centre conducting the dealing, provided that a liquid position is maintained, remembering that a large proportion of these funds is repayable at short notice.

The organization of banking institutions should be technically adequate to perform the work of handling international finance. Bankers should be prepared to incur a reasonable amount of risk without, of course, undertaking business of an unduly speculative character. It is of equal importance that the financial organization shall enjoy the utmost measure of freedom from official interference. Foreign banking institutions, for example, should be free to establish themselves without being made the object of discriminatory legislation. It is true that foreign banks will offer a certain amount of competition to domestic banking concerns, but they are unlikely to abuse the facilities which are given to them. In like manner it is inadvisable in the extreme that the Government should attempt to influence the course of foreign investment from motives which are purely political. There should be a large number of investors who are willing to invest in foreign issues, and no attempt should be made

[1] *The Fight for Financial Supremacy.*

to influence their choice except when the nature of their investments is likely to be contrary to public interest.

It is, of course, essential that a centre which aspires to the position of an international money market should possess a stable currency. The stability of a gold standard currency does not necessarily increase in proportion to the size of the gold reserve accumulated by the central bank. A far more important influence is exerted by the elasticity of the currency system itself, and upon the feeling of confidence which it can create in the mind of the public. Again, the market for short-term capital should be developed to as high a degree as that for long-term capital, and, where such a market is in existence, it naturally attracts a large volume of short-term funds to a centre, a considerable proportion of which tends to remain there more or less permanently and is available for reinvestment. But, if this last function is to be discharged effectively, then the foreign exchange market should also have attained a high degree of development.

Foreign exchange markets and discount markets are complementary to each other, for an active discount market which attracts foreign funds increases the activity of the foreign exchange market, while a good foreign exchange market, enabling the transfer of funds and the covering of exchange risks at minimum costs, tends to encourage the use of the discount market and the money market by foreign investors of short-term funds.[1]

LONDON AS AN INTERNATIONAL CENTRE. In pre-war days London held a predominant position as a financial centre by virtue of the enormous resources which she had invested abroad—the amount of which was continually being augmented by a surplus in the trade balance which was available for reinvestment. Over and above the resources of home investors, the stability of our social and economic structure created a feeling of confidence in the mind of the foreign investor, so that he was prepared to keep a large proportion of his wealth in London, and this became available for reinvestment abroad. In the course of the War, British capital resources invested abroad declined considerably owing to heavy sales of American securities. Again, although until the trade slump of 1931 the British balance of trade showed an annual surplus, this margin was not so great as in pre-war days, so that our power of investment has been

[1] Dr. Paul Einzig, *op. cit.*

impaired. In respect of the volume of resources for investment New York easily outstrips any other centre.

In respect of its technical banking organization, London still possesses powerful advantages over its competitors. Since the War, London banking institutions have improved their facilities, whilst the discount and acceptance markets offer services unequalled elsewhere. In consequence, London is still the centre which surpasses its rivals in the efficiency with which a vast volume of business is conducted with the least disturbance. This is in sharp contrast to the position in Paris where, although a large surplus of short-term funds exists, there is an almost complete absence of technical organization for dealing with it. The reason why London has been able to grant large amounts of short-term loans is that she possesses acceptance houses and discount houses which, being very highly specialized, are in a position to offer their foreign customers perfectly organized facilities. In Paris, on the other hand, in spite of recent efforts to develop such institutions, the results have been insignificant.

Another strong point in favour of the London market is its relative freedom from official control and interference in normal times. Since the removal of war-time restrictions, foreign banks are at liberty to establish branches, whilst there is a minimum of restrictions on the issue of foreign loans. In the case of Paris, however, the authorities frequently exercise their right to veto foreign issues. Unless a loan is likely to bring advantage to France, either politically or economically, there is little possibility of its being authorized.

TEST PAPER 6

1. In what respects is the expression "Money Market" misleading?
2. Give a brief outline of the organization of the London Money Market.
3. Describe the nature of the business done by bill brokers and by accepting houses, and the services rendered thereby to the business world.
4. Write explanatory notes on the following. Bullion market; Foreign exchange market, Market for long-term capital
5. With aid of the diagram on page 170, explain the various rates of interest which prevail in the money market
6. What, in your opinion, are the chief factors which determine the growth of an international financial centre? Illustrate your answer by a comparison of London and New York

CHAPTER VII

THE STOCK EXCHANGE

WE have already seen how, under modern conditions, the large-scale capital necessary to carry on many branches of business activity is collected in small amounts from investors over a wide area. The limited company, having its capital divided into a large number of transferable shares of low value, provides the requisite form of legal constitution, but this would of itself be insufficient. A large proportion of the capital invested in industry becomes " frozen " into fixed assets—plant, machinery, buildings, and the like, so that, once invested, it cannot easily be realized. But if the investor with relatively limited resources is to be asked to invest his capital in industrial enterprises outside his control, he will do so only with great reluctance if he knows that his investment will have to remain locked up for an indefinite period. To such a person, an investment usually represents a sum saved against a day of need, so that, in order to attract capital from this source, the investor must have confidence that the machinery exists for the realization of this capital, without any great loss, should the necessity arise. The device of a transferable share is the first step towards the realization of this goal, but having gone thus far, it next becomes necessary to provide some mechanism whereby those having shares for disposal may establish contact with those wishing to buy them. In other words, we have to establish an organized market for dealing in securities Herein lies the function of the Stock Exchange.

Hence, it is the function of a Stock Exchange to act as a market and give mobility to invested capital. It provides a ready means for dealing in those securities which appear on its official list, and, in the performance of this function, renders other services to the business community. Thus, it enables the holder of any of the securities in which it deals to form some idea of the fortunes of the concerns in which he has invested his capital. The official price list represents the mature judgment of expert dealers, and for this reason is worthy of attention. In this way the would-be investor is provided with a valuable index whereby he may discriminate

between sound and unsound propositions. Again, behaviour of Stock Exchange prices is now recognized as a valuable barometer of the general industrial situation The members of the Stock Exchange, constantly endeavouring to forecast the trend of business in the future, crystallize their judgments in the form of the prices which they quote, and thus provide the business community with an indication of the trend of business in general, as well as of individual concerns.

INVESTMENT AND SPECULATION. Since these terms are frequently employed in relation to Stock Exchange operations, it will be well, at the outset, to examine their meaning. There is a very real difference between investment and speculation, but it is subjective rather than objective, and depends mainly on the intentions of the person concerned It has been said that the result of an investment can be foretold with a high degree of accuracy, whereas a speculation is a matter of sheer chance. This, however, is a very rough-and-ready distinction, since an investment may be made with totally unexpected results. In general, the investor buys securities and holds them for the income which they yield, whereas the speculator is not concerned with the income from the shares, but with the possibility of making a profit from their immediate sale. Thus, according to Lavington, in *The English Capital Market*,

> When a person buys railway stocks for the interest they yield him, holds them and finally sells, market language classes him as an investor. If, however, he had undertaken the operation in anticipation of a profitable difference between the buying and selling price, market language would usually class him as a speculator.

Since income from investment is his primary aim, the true investor will limit his risk, as far as possible, by purchasing high-class securities with an unimpeachable record. In making his choice he will have regard, first, to the security of his capital, so that he will endeavour to avoid loss through market depreciation. Secondly, he will tend to purchase shares in which there is an active market, so that his investment may be converted readily into cash should the necessity arise. Thirdly, he will look for a dividend yield which is commensurate with the sum of money invested, although, in this connection, the greater the security of capital, the lower, in general, will be the yield of the stock.

Turning now to speculation, there are many who consider that this is synonymous with gambling. Speculation, as we shall use the term in these pages, depends upon the exercise of discrimination and intelligence, whereas gambling calls for neither of these qualities but depends merely upon chance. The speculator is a skilled dealer who trades in securities between two points of time, with a view to gaining a profit on a price difference Lavington compares his operations to those of a trader; "the typical undertaking of the speculator is to buy goods from people at one time, carry them and sell them to people at a later (or earlier) date. His operation may be said, therefore, to consist essentially in an act of transport between two points of time, terminated by a purchase or a sale." The speculator deals with risks which are inherent in industry—risks which must be borne by someone if production is to be carried on at all. The dealer on the Liverpool Cotton Exchange who speculates in price fluctuations in cotton merely assumes a risk which would have to be taken by the manufacturer in the absence of the organized exchange. In gambling, however, the risk is an artificial one, created by the transaction itself and is greater than is justified by the chance of profit. The relationship between speculation and gambling is, as Hardy points out in *Risk and Risk-bearing*, that "Speculation is not a form of gambling, gambling is a form of speculation."

In discussing the economic value of the work of the speculator, Lavington points out that, inasmuch as the speculator deals in future values, it becomes difficult to estimate accurately the value of the commodity which forms the subject of exchange. The skilled speculator may take advantage of his special knowledge to extract from the public a profit out of proportion to the service which he renders. On the other hand, any tendency in this direction is apt to be checked by the pressure of expert competition, forcing prices into conformity with the best informed anticipations. In regard to the influence of speculation on price, Lavington enumerates the following conclusions—

1. Speculative operations in which special knowledge is employed to anticipate changes in the investment values of securities not subject to speculative booms establish a truer course of prices, and, consequently, increase the efficiency of the market.

2. Skilled speculative operations in markets for securities of variable and uncertain value are ambiguous in their effects. On the one hand, they tend definitely to distort prices when they are employed to initiate or foster a speculative boom, on the other hand, they correct the false valuations of the public when they are employed, for example, to bear sales during a boom, or in the purchase of undervalued securities when the boom has collapsed.

3 Unskilled speculative operations carried out independently in the investment markets cannot in general improve prices, but they are likely to increase their variability and, consequently, to lower the efficiency of the market.

4. Unskilled speculative operations, governed largely by irrational herd impulses, produce effects on prices which are wholly bad and lead to heavy social waste

A skilled speculator may make a valuable contribution to economic welfare, but an unskilled speculator, who is nothing more than a gambler, leads to uncertainty and waste. In this connection Professor Henry Clay has denounced three types of speculative activity, namely, speculation by the outsider, dealing with insufficient capital, and producing artificial price fluctuations which cannot assist in adjusting supply to demand. When once an organization has been established for making regular dealings in any commodity, whether it be wheat or securities, anybody can make use of those facilities. It is true that they may be precluded from dealing directly by the rules of the exchange, but they can transact business through others. But unless speculation is based upon foresight and experience, supported by accurate information, it is apt to do more harm than good. A great deal of the information upon which the amateur speculator bases his judgments has already been acted upon by the professional dealer, so that any move by the outsider may produce effects quite the reverse to those which he anticipated. Even where the information is genuine, therefore, the scales are heavily weighted in favour of the professional speculator, but the position is still worse where the statements have been judiciously framed with a view to deceiving the unwary. Hence speculation is the work of specialists with inside knowledge of the markets in which they are dealing, for, as Mr. Hartley Withers points out—

Those who are in the centre and on the spot and "in the know" (though this last position is sometimes extremely dangerous and expensive) always have an advantage over the outside public, however carefully the latter may study the prices in the evening papers; because to be able to close a commitment at once, before the bloom is off the cheek

of a market, will often make all the difference between profit and loss, and is certain to make a big difference to the extent of the loss, if it has to be faced.[1]

Speculation with insufficient funds is a characteristic which is typical of the amateur dealer. It was a prominent feature of the stock market boom of 1928 and 1929 in the United States, and is encouraged by what is known as the margin system. Under this system a broker will purchase specified stock exchange securities upon receiving a deposit of from 5 to 20 per cent of the total amount of the purchase. If, after buying, the securities rise so that they can be sold at a profit, then the speculator gains the amount of the increase, less a deduction for expenses. On the other hand, if the value of the securities falls, then the speculator loses this amount together with the broker's charges. When the fall is so heavy as to absorb the entire amount of the deposit, then the speculator must find more money or the shares must be sold before the price sinks further The evils of this system were clearly seen in the New York Stock Market boom of 1929. Small investors all over the country had employed the whole of their savings in marginal dealing. When the decline in security values took place these margins disappeared in the course of a few hours, and when brokers called for more funds to cover the losses due to further declines, their customers had no reserves to fall back upon. Consequently the loss fell upon the brokers and the action of the latter, in attempting to sell their holdings to minimize their losses, merely aggravated the downward movement of prices.

Legitimate speculation, carried on by skilled dealers, tends to mitigate price fluctuations. This advantage is, of course, most evident in the case of the commodity markets where undue fluctuations in the prices of raw materials and foodstuffs are injurious to producers and consumers alike. Yet it is obviously to the interest of the speculator that price fluctuations should occur, for it is on the basis of differences in prices that he makes his profit. Hence there are many dealers who are prepared to manipulate the market with the object of causing price movements profitable to themselves. Such methods are obviously anti-social, and the exchange authorities strive to minimize such activities. In so far as many of these manoeuvres are

[1] *The Quicksands of the City*

conditioned by the innocence or cupidity of outside speculators, adequate protection is impossible.

RISE OF THE STOCK EXCHANGE. Speculation has had a very chequered history and has attracted no small amount of odium. In his famous Dictionary, Dr. Johnson could find nothing better to say of a stock-jobber than that he was "a low wretch who gets money by buying and selling shares in the funds." Writing in 1858, the best that Maunder could say was, "Speculation on a large scale, upon the principle of monopolizing, or that kind of speculation which consists in the purchase and sale of shares in public companies, as well as 'dabbling' in the stocks, and a variety of other hazardous transactions which might be named, are different species of gambling and are often no less ruinous." Whatever the ethical aspect may be, speculation appears to be an inherent characteristic of human nature, and has appeared in various forms at all periods of human development. Confining our attention to that form of speculation connected with the Stock Exchange, we may note that Florence in the fourteenth century possessed a kind of immature Stock Exchange upon which shares in the public debt were dealt in as they fluctuated in value. The London Stock Exchange was recognized by law in 1697. The Act was, in reality, designed to regulate stock-jobbers, who bore no enviable character, and were regarded with strong disfavour by the mercantile brokers of the Royal Exchange, who objected to their presence.

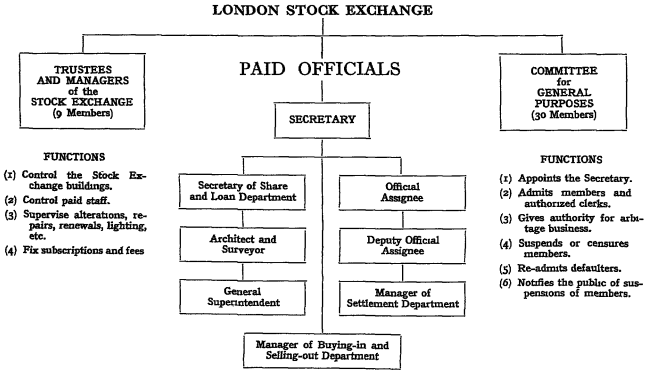
In consequence, in 1698, there was a general exodus of the jobbers to Change Alley, which provided them with a suitable open space, undisturbed by traffic, and with convenient coffee houses. Although attempts were made to dislodge the jobbers and compel them to return to the Royal Exchange, where some supervision could be exercised over them, no change occurred, and they continued to transact business in Change Alley, which, to all intents and purposes, became the Stock Exchange. The new institution, then known only as "the jobbers in Change Alley," soon found itself plunged into the first Stock Exchange crisis, for in 1720 the financial collapse, known as the South Sea Bubble, occurred. Yet the jobbers survived their troubles even though, in 1733, an Act was passed to render speculative dealings in stocks illegal. The Act proved a dead letter and made no difference to the dealings carried on. In

1799 another big step forward was taken, when the brokers raised a capital of £20,000 and built the Stock Exchange in Capel Court. For some years afterwards, certain branches of business were carried on elsewhere, but in the course of time all were gathered into the one institution.

In 1877 a Royal Commission was appointed to inquire into the constitution and customs of the Stock Exchange. The Commissioners found that the existence of the association was definitely in public interest. They considered that a searching inquiry should be made into the character and position of proposed new members, and subsequently a sub-committee was set up for this purpose. The Commission exonerated the institution from the charge that it encouraged gambling. It was suggested that the Committee should exercise a restraining influence over any tendency to excessive speculation, so far as this was possible, but that it was not practicable to render gambling business any more illegal than it already was. The Commissioners dealt with the question of quotations in the Stock Exchange Official List, and considered that there was a tendency on the part of the investing public to place too much reliance on the list as a guide to the status of a concern. They considered that it should be made clear that admission to the list implied nothing further than that the company had complied with certain prescribed formalities.

ORGANIZATION OF THE LONDON STOCK EXCHANGE. The London Stock Exchange may, for all practical purposes, be regarded in the light of a club whose object is the transaction of business in stocks and shares. The building itself is owned by a private joint-stock company, whose shares are held by the members of the Exchange. Although the Royal Commission of 1877 recommended that the institution should be incorporated by Royal Charter, this has never been carried into effect. As a private institution, its management owes no duties to the public, and its business is subject to no regulations other than those which, from time to time, the Committee for General Purposes thinks right to impose on the members. Its prestige and authority depend entirely upon the reputation it has established for honest and efficient business methods.

The institution is administered under a system of dual control, the responsible bodies being—


LONDON STOCK EXCHANGE
TRUSTEES AND MANAGERS of the STOCK EXCHANGE (9 Members)
PAID OFFICIALS
SECRETARY
COMMITTEE for GENERAL PURPOSES (30 Members)
FUNCTIONS
(1) Control the Stock Exchange buildings.
(2) Control paid staff.
(3) Supervise alterations, repairs, renewals, lighting, etc.
(4) Fix subscriptions and fees
Secretary of Share and Loan Department
Architect and Surveyor
General Superintendent
Official Assignee
Deputy Official Assignee
Manager of Settlement Department
Manager of Buying-in and Selling-out Department
FUNCTIONS
(1) Appoints the Secretary.
(2) Admits members and authorized clerks.
(3) Gives authority for arbitage business.
(4) Suspends or censures members.
(5) Re-admits defaulters.
(6) Notifies the public of suspensions of members.

1. **The Trustees and Managers** who are the representatives of the shareholders or proprietors of the Stock Exchange. These are nine in number and collectively constitute the governing body. Before any person can be elected to this position, he must have been a member for the previous five years and must hold at least ten shares at the time of his nomination. The managers regulate admission money, appoint all the officials except the secretary, and generally manage and control the building and its accommodation.

2. **The Committee for General Purposes** which watches over the interests of the members and supervises their methods of dealing. It consists of thirty members, who hold office for twelve months, and in order to be eligible for election to this body a person must have been a member for at least five years. The Committee meets at least once a week, and it is doubtful whether any voluntary institution is governed by a body of men with more arbitrary power. It can revise and amend the code of rules governing the operations conducted on the Exchange. It may expel any member for improper conduct, for violation of rules or failure to comply with the Committee's decisions, and may censure or suspend any member for acting in any way detrimental to the interests of the Stock Exchange. The Committee is assisted in its work by a number of paid officials, namely, the Secretary, the Secretary of the Share and Loan Department, the Official Assignee, the Deputy Official Assignee, the Manager of the Settlement Department, and the Manager of the Buying-in and Selling-out Department.

MEMBERSHIP OF THE EXCHANGE. The tradition of the Stock Exchange for honest and straightforward dealing makes it necessary that the Committee should investigate every application for membership with great care. In consequence, every applicant must be recommended by three guarantors, who must themselves have been members for not less than four years. Each guarantor must stand surety for the new member for a period of four years—a sum which is handed over to his creditors should he fail within that time. Every member must make a new application for membership once a year, although the entrance fee is, of course, payable only on first admission.

The members of the Stock Exchange are divided into two classes—jobbers or dealers, and brokers. The constitution of the London

Stock Exchange differentiates sharply between them, laying down that a member may be one or the other, but not both at the same time, and that a dealer may not deal directly with the public This position, which is peculiar to the London Stock Exchange, has its advantages to the public, who would be at an obvious disadvantage in dealing directly with a market professional such as the jobber.

The Jobbers. The technical position of a broker is that of an agent, but the jobber acts as a principal. He makes his profits from what is known as the jobber's " turn," that is, the difference between the price at which he is willing to buy and that at which he is willing to sell. It is the business of the jobber to buy or to sell securities and to " carry " the purchase or sale until such time as he can complete the business by making a contrary transaction. The jobber acts as a specialist in a limited class of securities, and is, consequently, able to keep his finger on the pulse of the market. As a result of this organization, a broker, with a buying or a selling order from a client, knows immediately to what section of the market he must go in order to find a dealer ready to make him a price. The jobber's " turn," therefore, is, as Lavington points out, " the payment which he requires for the trouble and risk involved in completing the first deal, in bearing the risk of fluctuation of price during the interval which elapses before he can undo his bargain and in completing the subsequent deal."

The position of the jobber has not failed to attract criticism, and it has been contended that the size of the jobber's " turn " is occasionally out of proportion to his services in making a price, and that he may even refuse to make a price at the moment when such a service is economically most desirable. With regard to the first of these complaints, it must be remembered that the jobber does not make a price in accordance with his own whim or fancy The price of securities, like that of any other commodity, is determined mainly by the interactions of supply and demand. Again, the jobber has no monopoly, but is in competition with others in the same market, and this fact alone will serve to limit his margin of profit. With regard to the second point, it is the function of the jobber to find stock with which to supply purchasers and, conversely, to discover purchasers who wish to take stock which is

offered, and he must, in the performance of these duties, be prepared to take the ordinary business risks which attach to selling stock that one does not possess, and buying stock for which there is no immediate prospect of sale. Yet, for all that, there is a limit to what can be expected of the jobber, and no man, however ample his resources, is able to assume more than a certain amount of responsibility. There must come a time when the jobber feels that it is dangerous to make prices, because he does not know where to replace what he has sold or to sell what he has bought and must pay for.

We may sum up the economic contribution of the jobber in the words of Lavington—

> The Jobber is both trader and speculator; as speculator he brings into business contact buyers and sellers separated by time. In the absence of this contact the public could buy securities—and, what is more important, they could sell securities—only if there were already in the market some other party ready to deal in a contrary direction, or, alternatively, they could buy and sell only by offering to deal at a price so unfavourable to themselves as to attract some other party into the market. The important influence which such a condition would exert in checking the supply of capital against negotiable securities is the measure of the value of the Jobber's services.

The Brokers. These are members of the Stock Exchange who act as agents for others in connection with the purchase or sale of shares. They are allowed to act as agents for any member of the general public, or for another member, including a jobber In the ordinary course of things, however, a broker's duty is to act for a client who is a member of the public, and he is engaged either to sell or to purchase from a jobber securities which his client is desirous of acquiring. He is required to have a general knowledge of the markets in which he is called upon to deal, but inasmuch as his operations cover a wide field, he cannot hope to attain to the specialized knowledge of the jobber in any given market. To this extent, therefore, the protection which the broker can offer the general public against the specialized jobber is limited. The work of the broker is necessarily more arduous than that of the jobber, involving longer hours and the exercise of unlimited patience, since he has to make allowances for the fact that the majority of his clients do not grasp the intricate details of his highly technical business. The broker must act as guide, philosopher, and friend to those

members of the public who enlist as his clients, or, as Lavington says—

> The Broker is the expert agent of the public. His skill and experience enable him to advise clients with regard to the transactions which they undertake, and to put his clients on equal bargaining terms with the Jobber in carrying out those transactions. He serves in effect as a kind of ring fence round the Jobbers, protecting the public from contact with dangerous machinery—dangerous, of course, not from any moral weaknesses on the part of the Jobbers, but because the superior knowledge of the value of securities possessed by these experts would in many cases place the public at a disadvantage in dealing with them directly.

Apart from actual dealing, a broker is often called upon in an advisory capacity to give information to his clients about securities in which they are interested.

Mention may be made at this point of the " outside broker " who is not a member of the Stock Exchange. These dealers, being outside the influence of the Stock Exchange Rules, can advertise widely—a practice which is denied to members. A large amount of this business is of a fraudulent nature, whilst other transactions can be described only as a gamble on the rise or fall of prices.

Every member is allowed to introduce three clerks into the House, or, in the case of a firm, the number may be increased to five. The first of these is known as an **Authorized Clerk.** An individual member can employ one of these, and a firm two. An authorized clerk is one who is empowered to transact business on behalf of his employer exactly in the same manner and under the same conditions as he would do so himself. The other clerk is known as an **Unauthorized Clerk,** who is allowed to enter the House but is in no circumstances allowed to deal. He is employed merely to convey messages and to perform similar services. Finally, there is a third type of clerk, who may not enter the Stock Exchange proper at all, known as a **Settling Room Clerk.** He may be admitted only to the Settling Room and is employed in checking bargains and in carrying through arrangements in connection with the settlement of transactions.

STOCK EXCHANGE DEALING. As we have already seen, the broker is the member of the Stock Exchange with whom the members of the general public deal. A person who has funds which he wishes to employ in the purchase of stock exchange securities will therefore

instruct his broker to purchase such shares as he requires. Should he be in any doubt as to his best course of action, he may seek the advice of the broker himself, who will give him the benefit of his practical experience freely and without obligation. When he has received definite instructions from his customer, the broker can approach a jobber who is dealing in the particular "market" in which he is interested, and ask him to make a price for the shares in question. In so doing, he offers the jobber no indication as to whether he is buying or selling, so that the jobber is compelled to name two prices, at the lower of which he is prepared to buy and at the higher of which he is prepared to sell. If the broker is satisfied with the price quoted, he announces that he will buy a certain number of the shares, whereupon both parties enter particulars of the transaction in their notebooks. No document passes between the two parties as evidence of the deal, but on the next day their clerks will check the bargain in the Settling Room If there should be a disagreement—which is very unlikely—the matter is referred to the two principals. This casual method of transacting business in the House is possible only because of the high code of honour which members observe. The broker will, in due course, send a Bought Note to his client giving details of the purchase and of the amount payable, including his own commission, stamp duties, and transfer fees.

The jobber has sold the shares to the broker, but in all probability he has no such shares in his possession, so that it will be necessary for him to obtain them before the date of delivery arrives. He will therefore establish contact with another jobber who has these particular shares to sell and, according as he succeeds in buying them at a lower or a higher price than that which he quoted the broker, he makes a profit or a loss on the transaction. The settlement of the majority of Stock Exchange bargains does not occur on their inception, but at the end of the current Stock Exchange Account, which falls in the middle and at the end of each month. Then, under the regulations of the Stock Exchange, all bargains must be completed. The settlement normally occupies four days, the first of which is known as *Contango Day* when those who have bought or sold securities which they do not wish, at the moment, to receive or deliver, endeavour to make arrangements for carrying over the transaction

to the next Account. Thus, a broker who has bought shares but does not wish to take delivery of them, arranges with another dealer to purchase them temporarily, but agrees to take delivery of them for the next Account. The stock changes hands at the "making-up price" which is fixed by the leading jobbers in the market and is an approximation to the market price of the shares on Contango Day. Any difference between the original purchasing price and the making up price is payable immediately. The amount charged for the accommodation is known as Contango Rate.

The second day of the settlement is termed Ticket Day, when contact is established between the ultimate buyers and sellers of securities. The buying broker, who is to take delivery of the shares, makes out a "ticket" bearing his name, that of his client, and that of the dealer from whom he has bought the shares. In addition, it will give details of the securities and the price fixed. This is handed to the member who sold the shares and, if he, in turn, has bought them from someone else, he endorses the ticket and passes it on until ultimately it comes into the hands of the dealer who has to deliver the securities. The third day—"Intermediate" day—is utilized for the preparation of documents, whilst the last day is known as Account Day, when payments in respect of all transactions entered into must be made.

STOCK EXCHANGE PRICES. We have indicated that the stock exchange is a market in which transactions in securities may be made in accordance with certain well-defined rules. It provides a market in which capital already invested may change its ownership. We may, therefore, ask ourselves—what will determine the market price of a given class of securities at any time? We may say, with a fair degree of truth, that the price of a security will depend on the relation between the supply of and the demand for it, but this statement, of itself, does not shed much illumination on the problem. We require to know much more about the conditions of demand and supply before we can return an answer.

A powerful factor in determining the valuation which the market will place upon any security is the confidence inspired by the institution which issues it, but the basis on which that confidence rests is in itself complex and varies according to the type of security. First let us consider the case of a government bond. In the first

instance, the general attitude of the market towards that security will be influenced by the reputation and past history of the issuing government. If it has a long record of good faith towards its creditors and no serious defaults, in recent times at all events, then the tone of the market is more likely to be favourable. But the past reputation of a country is only one factor, and may be relegated to a very subordinate position by considerations of the present economic status. Thus, the past record of Great Britain for honouring her obligations stands second to none, yet, in September, 1931, foreign investors took alarm at her economic position, and gilt-edged stocks slumped heavily. Revelations of excessive government expenditure, an unbalanced budget, heavy commitments abroad, and an "unfavourable" balance of trade, undermined confidence and forced prices of British Government stocks down. Lack of confidence in one type of security may spread to others which are associated with it in the mind of the investing public, even though there is no actual ground for distrust. This was clearly seen on the New York foreign bond market in the autumn of 1931. Defaults in South America and distrust of the European situation demoralized the market to such an extent that prices of the bonds of countries which had not defaulted were marked down at as low a level as those which had. Prices fell because all the dealers in the market were wishing to sell whilst there were no buyers. Again, anticipation of future events will assist in determining the attitude of the market—the crop forecasts on an agricultural country, the possibility of labour unrest, a pending election—all such events will influence the demand and supply of securities of that state.

Consider now the case of an industrial security. The most obvious factor influencing the market valuation of the shares of a trading concern is the rate of dividend which the directors from time to time declare. The higher and more steady the rate of dividend, the greater is the demand likely to be, and the higher the price. But the rate of dividend paid out is, after all, a very superficial test. It is not the habit of the directors of a well-managed company to distribute all profits earned. Substantial allowances will be made for depreciation, sums will be allocated to reserve, so that the most relevant point is not the amount of dividend *distributed* but the dividend which has been *earned*, that is, which would have been

available for distribution had the directors pursued a less cautious policy. The market valuation of the shares does not by any means stop at this point, but much will depend upon estimates of the future earnings of the undertaking. In this connection the past progress of the company, the nature of the market for its product, the composition of its board of directors and the quality of its management, will all exert some influence. Over and above all these influences which, after all, are based largely upon objective tests, there still remains the psychological attitude of the buyer who, motivated by a spirit of speculative optimism, may cause the price of the shares to be driven up to a much higher level than is warranted by any of the foregoing tests.

Over and above these influences which are associated directly with the securities, there are other forces at work influencing the tone of the whole market One of the most important of these is the credit policy of the central bank as evidenced by the Bank Rate. A high Bank Rate causes heavy selling of securities, since much stock exchange business is conducted on a basis of borrowed money, and high interest rates cause it to become unremunerative. Operators, consequently, liquidate their holdings in order to repay, and this forced selling depresses prices. As Mr. Hartley Withers expresses it, speculators and investors find that "a shuddering palsy has fallen on markets, and that prices are shrivelling and withering, without any respect for the intrinsic merits of securities" This is a factor which is of considerable importance at the present day, when changes of the Bank Rate are frequent.

THE INVESTOR AND THE STOCK MARKET. In pre-war days it was considered indisputable that the investor who desired a steady income with the minimum of risk should invest his savings in government securities or other trustee stocks, or in fixed-interest securities such as debentures and preference shares. Ordinary shares were regarded as speculative and unsafe for the ordinary person to buy. These conclusions are still held in many quarters, but their accuracy is no longer held to be beyond dispute, for recent events have had a disturbing influence upon old beliefs. The steadiness of the income obtainable from fixed interest securities is a matter which cannot be denied so long as we are content to measure income in terms of money. In our day, however, it is very doubtful if many people

remain who are satisfied to do so, and most have been driven by sheer force of circumstances to see that it is the purchasing power of income which matters.

Judged from this standpoint, the merits of "safe" fixed interest securities become somewhat more questionable. As Mr. J. M. Keynes has shown,[1] "the owner of Consols in 1922 had a real income, one half of what he had in 1914, and one-third of what he had in 1896. The whole of the improvement of the nineteenth century had been obliterated, and his situation was not quite so good as it had been after Waterloo." The fall in the general level of prices which has occurred since 1922 has improved the position of the investor, but in these days of monetary instability his lot is precarious. This position has given rise to a change in investment principles which Mr. Hartley Withers has described as "the cult of the ordinary share"—in the belief that the investor finds the greatest security of income in the purchase of ordinary shares. It has been shown as the result of a series of tests taken over different periods of time that the income from a selected group of ordinary shares is higher than that from a similar group of fixed interest securities, though subject to relatively large fluctuations from year to year. In order to obtain the best result, the investments must be selected judiciously and must be diversified so as to cover a wide range of different enterprises.

In a book written shortly after the Hatry crash in 1929, Mr. Hartley Withers[2] uses this fact as one powerful argument to show that the work of investment is something which cannot successfully be carried out by the amateur. Individuals have not got the skill, time, and knowledge to select securities so as to obtain the maximum of income and the minimum of risk. Furthermore, they have insufficient resources to devote to the task. He, therefore considers that the ordinary investor must delegate this duty to a body of specialists in the form of a reputable Investment Trust Company. By purchasing shares in such a concern, he places resources at the disposal of those who can make best use of them, and his own work is confined to the task of selecting the company to which he will entrust his savings.

[1] *A Tract on Monetary Reform*
[2] *The Quicksands of the City*.

TEST PAPER 7

1. Speculation is often decried, but there are certain conditions which render it quite legitimate and of benefit to the community in general What are these conditions?
2. In what ways does the existence of an organized Stock Exchange facilitate the financing of industry?
3. "Stock Exchanges render capital liquid and available"
   Explain the meaning of this statement, and describe how the London Stock Exchange helps in the provision of capital for trade and industry.
4. State in what way the Stock Exchanges serve as a barometer of economic conditions.
5. Show briefly the relationship existing between the Stock Exchange and (*a*) the money market; (*b*) the industrial world.
6. Comment on the distinction between speculation and investment Show its importance, and the uncertainty of the demarcation between the two
7. Outline the history of the development of the London Stock Exchange.
8. Give a short account of the organization and government of the London Stock Exchange.
9. What social service is performed (*a*) by the company promoter, (*b*) by the stock jobber?
10. Members of the Stock Exchange are divided into two classes. Describe the functions of each class
11. What is the Stock Exchange List, and what purposes does it serve? What matters are included in the List?
12. Explain the meaning of the following terms in relation to the Stock Exchange—
    (*a*) Settling days.
    (*b*) Jobber.
    (*c*) Making a price.
    (*d*) Dealing in futures.
    (*e*) Contango.
    (*f*) Hedging

CHAPTER VIII

NATURE AND SIGNIFICANCE OF FOREIGN TRADE

THE infinitely varied, extensive, and highly developed needs of mankind are satisfied in accordance with the principle which is best described as that of the social division of labour. This expression signifies that the members of the economic system specialize in the production of a certain kind of article or service which they exchange for the commodities they require for their own well-being. A moment's reflection will lead us to see that economic society, which is bound together by a system of production and exchange based upon division of labour, embraces the whole of the civilized world. Under such a system, the peoples of every region are engaged in a process of co-operation for the mutual satisfaction of their wants, and the most highly developed nations tend to become increasingly dependent for their welfare upon international trade.

We wake up every morning and put on clothes for which Australia supplies the wool; the United States and Egypt the cotton; Italy the silk, and Paris or London the fashion. For our breakfast we enjoy beverages which have their origin in Assam or Brazil, and consume wheaten bread without realizing that we are thereby availing ourselves of the fertility of the soil of the Prairie Provinces or the plains of the Argentine. In the course of the same meal we may eat New Zealand butter, Irish eggs, and Danish bacon. In eating bananas or oranges, we may be more or less dimly conscious of the fact that we are consuming the products of the West Indies, Spain, or California; but in reading the contents of the morning paper we do not heed the fact that the raw material probably comes from Canada or Scandinavia. The most radiant patriotism fails to prevent us from extending to the imported cigar preference to the home product. Our conscience is not quite so clear if, as members of the well-to-do classes, we use an American motor-car; but were we to select a British car it is well to reflect that possibly Mexico or Mesopotamia is the source of the petrol which we use, that the steel framework could not have been produced without the ore of Sweden or Spain, and that the tyres can trace their pedigree to the Malay

Peninsula. For the wooden paving of our streets we are indebted to Sweden and the other Baltic States, whilst it may easily happen that the bulk of our office machinery is manufactured largely in the United States. After having enjoyed an American film and listened to German music, we return home to rest on a bed whose feathers were imported from Hungary.

From this we see the nature of the material environment in which the great masses of the people which we call civilized carry on their daily life. Nobody will dispute the fact that our modern means of communication can transport us in surprisingly short spaces of time through many different lands, and that passengers and goods move in large numbers across the national political frontiers. Yet, with the inconsistency of human nature, man, after devoting great ingenuity and considerable effort to the development of inventions for increasing the mobility of persons and goods, then proceeds to concentrate all his energies on reducing such movement or even stopping it altogether.

HOME TRADE AND FOREIGN TRADE. The student of international trade should realize at the outset that the conduct of trade with foreign countries is effected through the activities of individual business men, in the same way as the home trade. The only difference is that instead of the second party to the transaction having his headquarters located in this country, he is to be found outside our political frontiers—say, in New York, Melbourne, or in Yokohama. Yet, though we speak frequently, and somewhat loosely, of "England trading with the United States," or with any other country, we must remember that it is individual merchants, located in cities overseas, which deal with their opposite numbers in this country. After all, at the basis of foreign trade there is nothing but the sober daily activity of millions of individuals of different nationalities who bargain, compete, and co-operate with one another, who buy and sell, incur debts, and contract credits, finding in these transactions a means of existence

All this can be understood without difficulty, and is scarcely calculated to raise opposition. Yet, we may go a step further, and assert that international trade is regulated by very much the same principles as trade within the nation, and that many of the problems of international trade are more apparent than real—a fact which we

shall endeavour to illustrate in a subsequent chapter. Indeed, this could scarcely be otherwise when we consider that the political frontiers of a State are of an entirely arbitrary nature. What, for instance, distinguishes the exchange of goods between merchants in Great Britain and France from that between dealers in Great Britain herself? What difference is there in the transactions between London and Paris, or London and Glasgow? When the Irish Free State was created in 1922, the mode of business of a merchant situated in the new state in dealing with another in Northern Ireland did not undergo any subtle change and assume a different character. There is quite obviously no essential difference whatsoever between home and foreign trade, except that in the latter case we find one contracting party beyond our own political frontiers, thus leading to the extension of the sphere of the division of labour. There are admittedly complications which man in his wisdom sees fit to invent when goods pass over national frontiers, but these do not change the basic nature of the transaction.

International trade arises from considerations similar to those which determine the direction of the home trade of a country: we buy where we can buy cheapest, and we sell where we can obtain the highest price. Anyone who understands the structure of modern industry based upon division of labour can readily appreciate why we no longer live in caves like the men of the Stone Age, and knows why the worst-paid labourer of to-day has facilities at his command of which the Pharaohs of antiquity did not dream. Is it logical to suppose that these advantages immediately disappear merely because the social division of labour passes beyond the confines of the State and becomes international? In its very nature, division of labour is two-sided, and mutual advantage accrues to both parties. Should the insistent voice of patriotism whisper into our ears that we sin against the Mother Country if we buy French soap, American motor-cars, or Californian oranges, we are already conscious of the nature of this warning. Likewise we might warn the inhabitants of South Wales not to buy any cheese from Cheshire, and the inhabitants of Bolton not to drink any beer from Burton. The object of all these admonitions is to induce us to renounce the principle on which the continued survival of our modern densely-populated communities stands or falls. Yet, just as the natives of Bolton can drink

no beer from Burton without returning goods or services of some kind or other, so also the English consumer of French wine must realize that, in return for this wine, the Frenchman will expect to receive goods of some kind.

But, it will be argued, the above example is not necessarily true. The beer drinkers of Bolton pay for their beer in money and not in, say, cotton goods. Upon receiving this money the manufacturers of Burton may elect to spend it in South Wales, so how does Bolton benefit? We may admit this objection without abandoning our argument. The people of South Wales have now a certain amount of purchasing power at their disposal which they can expend in Bolton so that the final result is the same to Bolton. The purchases of beer by Bolton men have led to a sale of the cotton goods which they produce—always assuming that the goods are of a type which other people require and are sold at a reasonable price. A very similar argument holds good in international trade, as we shall see later.

In spite of the fundamental similarity which exists between home and foreign trade, certain peculiarities distinguish the latter from the home trade and invest it with a certain light and colour. These integrating factors associated with the home trade can best be understood in connection with the results which accrue from the splitting up of the world into political units known as States. That the importance of this separation is not a small one can be seen from the way in which even the local authorities such as urban districts, municipalities, and other areas tend to separate themselves as economic units from their neighbours and pursue a policy of "splendid isolation." In the case of the State, the most important expression of this tendency is to be found in the influence which it exerts upon foreign countries through its tariff policy, by the levying of import duties at the frontiers. If there were no customs duties the frontiers of the State would lose much of their political significance.

Moreover, the State is a political union of peoples with a common heritage, which, in turn, is conducive to the development of uniform economic characteristics. All those things which constitute a "nation" such as common origin, common codes of morality and customs, common laws and religion, tend to influence the outlook and actions of the individual members in their economic dealings

as well as in other branches of activity. Herein is to be found some explanation of the fact that in international exchange, labour and capital are less mobile than in the home trade. Both in the methods of production and in the demand for commodities there is a greater uniformity in the home than in foreign trade, whilst in many business relationships and even in competitive conditions among the citizens of the same country, sentiment plays a large part—a factor which is largely absent when dealing with foreigners. Thus, in spite of the great development which has taken place in foreign trade in modern times, there still remain areas where dealings are made easier than would otherwise be the case by the existence of common ties and traditions. There exists, for example, a strong preference in many quarters for dealings with the Empire over those with foreign countries.

CAUSES OF INTERNATIONAL TRADE. When we speak of international trade, we refer to the exchange of goods and services by people in one country for the goods and services of people in another country. Trade between one nation and another is the logical outcome of the development of the principle of specialization. It is evident that if the various persons within a given community find it to their advantage to concentrate on one particular branch of production in order to reap the full benefit from any advantages which they may possess, it will be likewise beneficial for such specialization to operate as between one community and another. The causes which tend to stimulate this "territorial division of labour" are of some importance, and it will be well at this point to summarize them briefly.

Natural Resources. Differences in natural resources are one of the most obvious causes underlying the growth of international commerce. A country which is deficient in any of the basic raw materials of industry, such as coal, iron ore, or copper, is obliged to resort to exchange in order to procure them. In like manner, a highly industrialized country, with a dense population and limited agricultural resources, is compelled to obtain food for its people by foreign trade. No matter how well provided a country may be in respect of natural resources, no one area can be said to be self-sufficient under modern conditions. The British Empire is extremely rich in natural resources, yet it does not produce sufficient cotton

and petroleum—two essential raw materials. Similarly, the United States, with an adequate supply of these, lacks rubber and tin.

Power Resources. Where manufacturing is highly developed, a country possessing resources of cheap power may attract raw materials and pay for them by the added value of the manufactures which are exported in exchange. Thus, Great Britain lacks most of the basic raw materials of industry, such as cotton, iron ore, much of her wool, rubber, and so on, yet her plentiful and cheap supplies of coal give rise to her great manufacturing activities and make possible her vast trade in finished goods.

Industrial Ability. The workers of a particular country may possess special capacities for certain classes of work, thus making specialization worth while, even in the absence of natural resources. Examples of this type are numerous and we may note the skill of the shipbuilders of the Tyne and of the Clyde, or that of the Lancashire cotton operative; the ability of the German in the application of pure science to industry is another example which is often cited. Special advantages of this nature tend to diminish with the development of world industry, and, in the words of Marshall, "The percentage of the world's trade which is governed by differences in natural resources is increasing, while that which is governed by differences of industrial phase, and of aptitude for particular sorts and grades of manufacture, is less now that formerly, but yet its absolute volume is increasing."

Economic Development. The greater the degree of economic development of a country, the greater its interest in international trade tends to be. It is true to say that it is only a poor nation which can afford to be self-sufficient, though men only too frequently fail to appreciate the fact. From 1922 to 1929, those who preached the doctrine of economic self-sufficiency were wont to point to the United States as an example of the successful results which follow on a policy of "taking in one another's washing." With the depression of 1929–32 the fallacy was disproved in the most effective possible way, and Americans, as well as their admirers, suddenly discovered that international trade had a very definite bearing on American prosperity. It has become realized that the United States has an exportable surplus of agricultural, mineral, and manufactured products, so that a not inconsiderable proportion of the wage-earning

population is strictly dependent on foreign customers for its livelihood. Unfortunately, however, it would seem that one-half only of the lesson has been learned, and that goods can be sold to others only if you are prepared to take, in exchange, those things which your customers can give you. This is a question which we shall have to consider more fully when we deal with the questions of trade restriction. For the moment we may note the fact that the higher the degree of economic development, the greater is the dependence on international trade.

EVOLUTION OF OVERSEAS TRADE. From an historical standpoint, foreign trade has always been sharply differentiated from home trade. The popular idea of a member of another nation was that, if he were not actually an enemy, he was at least a highly suspicious character. Foreign merchants were, therefore, allowed to reside in this country only for a strictly limited time and under strict supervision. The prejudice against foreigners in general was also directed against their goods, especially if they competed in any way with domestic industries. In the thirteenth and fourteenth centuries the merchants of this country began to take a greater interest in overseas trade, which began to be developed through trading companies. One of the earliest of these was the Society of the Merchant Venturers of England, the exact date of formation of which is uncertain, but its development coincided with the great growth in the English cloth trade. It arose as the result of the economic struggle with the German Hanse for the control of English commerce.

When England began to weave her own cloth and carry on the trade in her own ships, both the Hanseatic League and the Netherlands did everything in their power to keep her in the position of economic vassalage which she had held for centuries. Attempt after attempt was made to close the markets of Europe to English merchants. First the English ships were excluded from the Baltic, and then from the Netherlands; Spain and Portugal in their turn closed their markets against them, while a Papal Bull debarred British merchants from any participation in the trade with either the East or the West Indies. Yet, on account of the fact that these prohibitions were not put into operation at one and the same time, the Merchant Venturers contrived to defeat this attempt at an

economic blockade by breaking through it, first at one point and then at another.

England's foreign trade continued to make progress, whilst the Government, through artificial regulation, sought to stimulate it further. By the Navigation Act of 1651, the Commonwealth Parliament set itself to strike a fatal blow at the Dutch carrying trade. Foreign ships were forbidden to carry colonial products or goods of other countries to England, unless the ships belonged to the country producing the goods. Charles II continued this policy by the Navigation Act of 1660, making the regulations much more stringent. Thus, there gradually arose an elaborate system of trade regulations, the object of which was the promotion of national interests and the subversion of those of the foreigner—the system known as Mercantilism. According to this body of economic doctrine, the great object of trade was the preservation of national strength, and for that purpose it was thought that the great aim should be the accumulation in the country of a plentiful stock of the precious metals. It was thought that, whenever we bought foreign goods, there was a danger that money would be paid in exchange for them, thus depleting the stock of gold belonging to this country. For this reason, imports were to be discouraged, whilst exports were developed, so that, as a result of any transactions, this country would have the " balance of trade " in its favour.

In the older form of Mercantile theory, that known as Bullionism, enactments were made forbidding the export of silver and gold, but it was found practically impossible to enforce these. In consequence, various relaxations were introduced, allowing the merchant to export any gold which he had imported. But one piece of gold being very much like another, it was a perplexing business to distinguish the imported gold from that which it was desired to export, and an oath had to be made by the exporter. In consequence, a new profession soon sprang up, carried on by the Knights of the Post, who were prepared to take the oath that the exported gold was the same as had been imported. In consideration of their services they levied a toll of $1\frac{1}{2}$d. an ounce. With the increase in the trade of the East India Company, the position became impossible, since it was essential to their business that they should import and export bullion. Thomas Mun took up the case and, in

two works, *A Discourse of Trade from England unto the East Indies* and *England's Treasure by Foreign Trade,* he sets forth for the first time the principles of the mercantile system

The argument propounded by Mun was that, whilst it is desirable that money shall be brought into the country, this being the object of trade, yet, on the principle that it is wise to throw away a sprat to catch a whale, merchants should be allowed to export gold, provided that, on balance, this trade brought in more precious metal than was exported. To quote Mun's simile—

> If we only behold the actions of the husbandman in the seed-time, when he casteth away much good corn into the ground, we shall account him rather a madman than a husbandman. But when we consider his labours in harvest, which is the end of his endeavours, we shall find the worth and plentiful increase of his actions.

In this view, the object of trade was to produce a balance of gold and silver and gave rise to the expression, "balance of trade," which has been used in economic literature ever since, meaning an excess of exports over imports. Mun succeeded completely in convincing the people of his time, and his book became the accepted authority, which was translated into every civilized language. It expressed a doctrine which was universally accepted—that the business of trade was to bring in money on balance—a theory implicitly accepted by everyone who had made money, had inherited money, or those who envied the people who had money.

But, although this system represented the prevalent form of economic thought in the seventeenth century, we may discern the growth of a body of opinion hostile to it, which ultimately caused its downfall. Sir William Petty, writing as early as 1691, in discussing the prohibition of the importation of cattle and beef from Ireland on the score of protecting trade interests in England, says—

> "If it be good for England to keep Ireland a distinct kingdom, why do not the predominant party in Parliament make England beyond Trent another Kingdom and take tolls and customs upon the borders? Or why was there any union between England and Wales? And why may not the entire kingdom of England be further cantonized for the advantage of all parties?"

But such writings as this went unheeded by "practical" politicians and business men, and the downfall of the system awaited

the advent of Adam Smith, who ruthlessly attacked it in *The Wealth of Nations*. He says—

To attempt to increase the wealth of any country, either by introducing or by detaining in it an unnecessary quantity of gold and silver, is as absurd as it would be to attempt to increase the good cheer of private families by obliging them to keep an unnecessary number of kitchen utensils

By his work, he influenced deeply the trend of economic thought of his day, and did more than perhaps any other single writer to mould the policy governing foreign trade followed by this country

ADVANTAGES OF FOREIGN TRADE. The most obvious of the reasons why foreign trade should take place at all is that we thereby obtain those products which could not possibly be produced from internal resources, so that goods are available for consumption which could not otherwise be procured. So far as this country is concerned, tropical produce is a typical example of this class of commodity. Much of this produce is of a luxury type, such as fruit and spices, which are demanded by a people with a relatively high standard of living. On the other hand, a tropical plantation product such as rubber is one of the essential raw materials of modern industry, and must be obtained, through exchange, by every industrialized community. Trade of this type found favour even in the days of the most stringent mercantile restriction, since it was "non-competitive" and did not threaten any interests in this country.

Closely allied to this class of goods are those which could be produced by a country, but only at a prohibitive cost of production. In the words of Adam Smith, "By means of glasses, hot beds, and hot walls, very good grapes can be raised in Scotland, and very good wine, too, can be made from them at about thirty times the expense for which at least equally good wine can be bought from foreign countries." Modern science has made possible the production of many commodities, even in adverse circumstances, but the question of cost is all-important under normal conditions. Under the stimulus of war, when the pressing demand for commodities outweighed all other considerations, many remarkable examples were seen of how production could be stimulated even in the most adverse circumstances. Thus, the genius of the German chemists evolved a process for producing a synthetic form of rubber, which

might have been expected to render Germany independent of tropical plantations. But the conditions of war, when rubber or a substitute must be obtained, cost what it may, are vastly different from those of peace, and costs which may be faced in such circumstances become prohibitive when other sources of supply become available.

ADVANTAGES AND DISADVANTAGES OF FOREIGN TRADE

Advantages	Disadvantages
(1) It applies the principle of division of labour to international trade. Each country produces the commodities for which it has the greatest advantage.	(1) It tends to rapid consumption of the exhaustible natural resources of a country, e.g. coal deposits.
(2) It reduces the prices to consumers. The fact that the goods are imported shows that the price is cheaper than a similar home product.	(2) It exposes home industry to uneconomic competition from "dumping."
(3) People are enabled to enjoy the products of different climatic zones.	(3) It makes possible the introduction of harmful commodities.
(4) Supplies can be obtained from every part of the world, so that famine and scarcity can be avoided and violent fluctuations in prices are less likely.	(5) It sometimes dislocates home industries which are deemed to be of great social importance (e.g. agriculture in England).
(5) It encourages the adoption of new methods and improvements in production.	(5) Production in accordance with the theory of comparative cost tends to specialization in a few industries only, reducing the number of occupations suitable to the capacities of the inhabitants of any country.
(6) It tends to prevent monopolies, and promotes competition generally.	
(7) It leads to a better distribution of raw materials which tend to flow to the best place for the production of manufactured goods.	

The disadvantageous position in which we find ourselves through producing goods regardless of cost is not invariably so clear as in the case of Adam Smith's grapes For example, some wheat may be grown in this country under conditions more favourable than those prevailing elsewhere and, that being the

case, such produce will find a market. Yet, the mere fact that some wheat can be grown at a profit will lead to the laying down of wheat lands which cannot yield profitable crops at all. Now, if we lived in an ideal world, with perfect mobility of capital and labour, such land would quickly be diverted to other uses; but, as we are reminded with disconcerting frequency, that we have not yet attained to an ideal state, we find ourselves involved in considerable confusion. Because some wheat can be grown, there will be many who will ask why more cannot be produced, and we can be certain that the producer working below the cost of production will rapidly marshal some excellent reasons why his crop could be made to pay if only certain of the advantages of his competitors could be counteracted.

The case of sugar offers an example of an industry for the establishment of which, in this country, a plausible case has been argued. Until the eighteenth century, sugar-growing was regarded as a tropical industry, and cane sugar was without a rival, until in 1747 a German chemist discovered that he could make sugar from the juice of the sugar beet. The industry was first established on a commercial footing in France, under Napoleon, with State assistance, and throughout its history this method of stimulation has been adopted. For a long time this country remained without the dubious advantages which a home sugar industry could offer to her, preferring to utilize her facilities for cheap importation. The shortage of supplies during the War turned the attention of the Government to a consideration of the desirability of establishing a beet-sugar industry in this country, and in 1925 it was granted a subsidy to assist it through its early stages. Unfortunately, however, governments in other countries, actuated by similar motives, have been determined to develop supplies under their own control, no matter what the cost. In consequence there has occurred a tremendous over-production of sugar in relation to demand, and a disastrous fall in prices, until it is suggested that "at present world prices, in no country in the world can the sugar beet industry be maintained on a profitable basis unless supported by substantial artificial aid."[1] The lower the price of sugar, the more tariff protection or bounties have been increased. The governments which

[1] *Report on the Sugar Beet Industry*, Ministry of Agriculture, Economic Series No. 27.

have attempted to establish an industry without regard to the cost of producing the commodity or to the effects which their action would have on output and prices, find themselves involved with an increasing burden in their attempts to support what they have created. Legitimate producers have fallen victims to those interests which have deliberately preferred to obtain their supplies in a more expensive way than was economically necessary. Herein lies the danger of a failure to distinguish between what is possible and what is economically practicable.

It is through the medium of international trade that the consumer is enabled to exercise his option of buying in the cheapest market. When, for example, the wheat crop in Canada is disappointing and prices tend to rise, the consumer in this country can turn to other areas of supply—the United States, the Argentine, Australia, or British India, secure in the knowledge that similar conditions are unlikely to occur in them all. Take the case of another important foodstuff, namely, beef and beef products, for supplies of which Great Britain draws upon a wide range of countries in different parts of the globe, such as the Argentine, Uruguay, Australia, New Zealand, and the United States. Or again, in the case of dairy produce for which we pay some £70 millions a year, we divide our custom among a dozen different areas of supply all over the world. Such a diversity of supplies offers the best possible guarantee that the consumer will buy at the lowest possible price. If however, we tamper with the free working of the system and attempt to favour one area of production at the expense of others, we shall, in all probability, deprive the consumer of this advantage, and, as is quite conceivable, confer no lasting benefit upon the producer

The most remarkable case occurs when a country with superior powers of production may find it profitable to import a commodity for which it has an advantage in producing. This case is discussed by Professor Taussig in the following passage, relating to the United States—

> If a country, though under no disadvantage in a commodity, nay, though possessed of an advantage in producing it, has here a *less* advantage than in other commodities, the first will be imported. For example, labour in the United States is no less productive than labour in Italy or Russia; it is probably more so; none the less, hemp is imported from these countries. Labour in this country is no less productive in

producing flax fibre than labour in Belgium, or in making linens than labour in Germany or Ireland, but flax and linen are still imported, and this in the face of a considerable duty

The conclusion drawn from these facts is that each country tends to concentrate upon those lines of production in which it has the greatest relative advantage, as well as those in which it has an absolute advantage. To take a simple example, a great surgeon may be an excellent gardener, but if he possesses a large garden he will, nevertheless, hire a staff of men to care for it, even though his own ability in this direction is superior to that of any one of them. This principle, applied as between one nation and another, furnishes us with an example of international specialization—sometimes known as the territorial division of labour. Nowadays, the majority of people will recognize the undoubted benefits which arise from the application of the principle of division of labour within a community, even though they may deplore certain evil consequences which they attribute to the same cause, but many of these same persons will utterly refuse to recognize that precisely the same principles may operate between communities of different nationality and confer benefits which are as great on all of them. This point is aptly put by Professor Cannan in his *Review of Economic Theory*—

When we come to the concentration of industries not in different parts of the same "country," but in different "countries," we find the public of each country displaying a strange hostility to the concentration of any industry in any country but their own. Yorkshire does not think itself ruined because the cotton factories are in Lancashire, and Dorset quite calmly acquiesces to having to buy textiles from Lancashire and Yorkshire; no state or town in the United States believes itself injured because all the cash-register machines are made in one city. The people of the places where a particular industry is not concentrated know that they get the product of the industry cheaper because it is concentrated, and recognize that they would gain nothing by trying to produce it themselves. But when we come to consider concentration of industries not in different parts of the same country but in different "countries," we find the people of each country displaying the utmost animosity against the concentration of industry in any of the other countries. They do this even when some industries are largely concentrated inside their own country, although that very fact necessitates a certain concentration of other industries outside; a large majority of the people of Great Britain and Northern Ireland simply hate to think of the industries of producing cash-registers, typewriters, and sugar being concentrated outside their own country, while at the same time they would like to see that country supplying

the whole world with cotton and artificial silk goods. That the only object of exporting these goods is to get others in exchange they seem incapable of realizing

Again, it is through the medium of international trade that the consumer secures some degree of protection against the effects of monopoly. Home producers have to frame their policies to meet the action of their competitors abroad. If this competition is excluded or checked in some way, then the consumer is protected only by the competition existing between domestic producers. Should this prove too keen, it is more than likely that the producers, sheltered behind a tariff wall, will arrive at some agreement to limit competition and raise prices. The only limitation then imposed will be that prices must not be raised so high as to provoke outside competition, either from new producers in the home market, or from foreign producers who can now sell at a profit in spite of the protecting tariff.

OBSTACLES TO INTERNATIONAL TRADE. In view of these powerful advantages to be gained from international trade, it might logically have been assumed that the trend of world development would have been in the direction of the promotion of international commerce. Unfortunately, however, there have been other factors at work, particularly since the War, which have tended to raise up obstacles to the development of international trade. The full discussion of one of the greatest of these obstacles—the tariff—must be deferred to a later chapter, and here we shall attempt to describe the general nature of the forces tending towards restriction and control in the sphere of world trade.

It is still the custom, and probably will be so for many years to come, to date the whole of our misfortunes—economic and otherwise—from the time of the World War. Yet there is ample proof to show that certain of our greatest problems were steadily growing more serious even before 1914, and that, war or no war, we should have had to face them sooner or later. It is true that the War has, in all probability, precipitated them upon us sooner, and in a more acute form, than would otherwise have been the case, but their origin is certainly not to be found in the war period. Policies of economic nationalism, and a growing tendency on the part of the State to interfere in economic matters, were both clearly discernible

long before the War, though the latter event has served to intensify them out of all reason. Yet, having given due weight to this consideration, the war, together with subsequent changes and disturbances, profoundly affected the economic structure and activity of the world.

In Europe wealth was destroyed on an unprecedented scale, the value of property destroyed being somewhere in the neighbourhood of £2,000 millions at pre-war prices, exclusive of armaments, munitions, and other military supplies. The proportion of this loss falling on different nations varied in its amount and nature; Great Britain lost ships, whilst in France, mines and agricultural land were ruined. Yet, heavy as was the material destruction caused by the War, the dislocation which followed was even more serious. As was pointed out in the final report of the World Economic Conference in 1927, "the main trouble now is neither any material shortage in the resources of nature, nor any inadequacy in man's power to exploit them. It is all in one form or another a maladjustment—not an insufficient productive capacity but a series of impediments to the full utilization of that capacity." It has been shown by Professor Bowley that much of the physical destruction of capital was made good in something like two years, so that industrial equipment as a whole was probably superior to that in 1914 in the United States, the United Kingdom, France, and Belgium. The economic dislocations still persist, and have hindered progress at every turn.

In many industries plant and equipment was kept in use long after it would have been scrapped in the ordinary course of things. On the other hand, the plant of firms providing war material was extended and improved, particularly in the case of the metallurgical and the engineering industries. The countries of the world were driven off the gold standard so that their currencies were seriously disorganized and unable to stand the severe strain resulting from the financial difficulties which prevailed during the first years of peace. The amount of taxation rose sharply, whilst the amount of government borrowing increased more rapidly still, with inflationary reactions upon the price level. In 1920, of all the countries of Europe, the United Kingdom was the only one whose budget was balanced, whilst the currency of Albania was the only one on a gold basis. To these complicating factors were added new causes of

friction when a number of old territorial units were broken up by the Treaty of Versailles and new national boundaries were created.

From the end of the War until 1929 there occurred a continuous process of reconstruction under the new conditions. The first and most urgent task was the stabilization of the various monetary systems which had become hopelessly disorganized in the course of the War. For seven years the European exchanges fluctuated violently, although after 1922 the dollar exchange was kept relatively stable in several countries, and two years later the gold standard was introduced in Sweden. In 1925, when the United Kingdom returned to the gold standard, a large number of other countries followed her example and stabilized their currencies in relation to gold. In Belgium, France, and Poland inflation continued, however, and the currency depreciated. Yet in these cases also a reorganization of the monetary systems took place in the course of the next two years, and drastic financial reforms turned deficits in the public finances into surpluses, and thus reduced the governmental demand for advances from central banks. In returning to the gold standard, some countries adopted a policy of deflation, whilst others devaluated their currencies, and the various ways in which the return to gold was carried out have exercised considerable influence in subsequent years upon the economic life of the countries concerned During the years whilst these measures of stabilization were in progress, the conduct of business in Europe was very difficult and, writing in 1927, Mr. Loveday could say—

> Since 1918 there has been no year in which the economic revival of Europe has not been checked by some event or series of events which has dammed back the deeper flowing currents of economic progress—the slump in trade in 1920 and 1921, which spread east from the United States and Japan; the uncontrolled inflation in Germany, Austria, and Poland in 1922; the occupation of the Ruhr in 1923; the stabilization crises of 1924 in Germany and Poland; the slump of the French and Belgian currencies in 1925, which almost synchronized with the deflation difficulties in the United Kingdom, Switzerland, and elsewhere, the British coal dispute in 1926.[1]

The year 1925 marks in certain respects a turning point in post-war economic development. By 1925, it is estimated that the value of world trade, after making due allowance for changes in prices,

[1] *Post-war Economic Tendencies*, 1918–1925, reprinted in *Britain and World Trade*

was about 8 per cent greater than in 1913. Europe, however, had lost ground in relation to the rest of the world. Moreover, up to this date, the volume of world trade had increased less than production; in other words, a smaller percentage of goods produced entered into international trade than before the War. In the following four years these conditions were radically transformed. The increase in world trade outran the increase in production and, more important, Europe regained her pre-war trading position. As prosperity increased, the demand for foreign products, and particularly for industrial goods, rose, and trade increased despite the restrictive influence of tariff walls.

Although, prior to the great slump of 1929-32, the world had made considerable progress towards recovery, there have existed numerous obstacles to the full development of international trade. One of the most serious difficulties has been occasioned by the loss of purchasing power on the part of large numbers of overseas customers. The destruction of man power and capital, and the physical and economic devastation of large areas, caused by the War, naturally left the world in an impoverished condition. The War completely deranged the finances of a large number of states, and seriously impaired the working of the mechanism of credit on which the operations of modern trade depend. The reduced purchasing power, consequent on the unstable conditions and poverty prevailing in the countries most directly affected by the War, reacted strongly elsewhere. It affected the economic situation both in the overseas countries which were sources of supply of raw materials and foodstuffs, as well as in industrial countries such as Great Britain which required markets for manufactured goods.

The decline in purchasing power due to currency depreciation gradually became less serious as one country after another stabilized its monetary system. But, as we have already seen, when a large number of nations had stabilized their currencies in relation to gold, the drain of gold to France and the United States caused a rapid fall in the price level. This, of itself, imposed a serious check upon the development of international trade. In the first place, in a time of rapidly falling prices, there is always a temporary reduction in the will, as distinct from the power, of consumers to buy goods. This arises from a general expectation on the part of consumers that

prices will fall still further. There is a tendency to limit purchases to the minimum necessary to fill immediate needs, and to hold up big forward contracts as long as possible. But a falling price level has consequences much more serious than this upon international trade as events in recent years have shown only too clearly. In all periods of falling prices a characteristic feature is almost invariably the greater fall in the prices of raw materials and foodstuffs than in those of manufactured goods. The causes of this discrepancy are complex, but one or two indications of the reason for the difference may be given. The reactions of manufacturers and primary producers, particularly agriculturalists, to falling prices are of an essentially different character; the former restrict output, whilst the latter often attempt to expand production.

In the case of foodstuffs, the plan of production has to be completed at least twelve months before the crop is sold and, once the planting has taken place, the farmer must abide by the consequences. Thus an error may easily give rise to overproduction and depression of prices. To take one example, under the influence of remunerative prices and a rising demand, the Cuban sugar producers decided, in 1923, to expand production. The European beet sugar industry had not recovered from the dislocation caused by the War and, judging by its slow advance up to that date, it seemed improbable that the work of reconstruction would be completed under five years. Unfortunately, the expansion of the Cuban sugar industry coincided with the expansion of the beet sugar industry in Europe, and the resultant increase in production caused a heavy fall in prices. A somewhat similar state of affairs has been created in respect of other agricultural products.

An examination of price movements in the course of the depression of 1929–32 shows that in the majority of cases the prices of raw materials have fallen more seriously than manufactured goods. The relationship between the prices of raw materials and industrial goods is obviously of the greatest importance, particularly in international trade, which is largely based upon the exchange of these two commodity groups.

In the economy of the modern world specialization has reached a very high point. Some countries, such as India, Australia, Brazil, the Argentine, and Canada, depend to a very large extent on their exports of certain

vital foodstuffs and raw materials, which a second group of countries—Great Britain, Germany, Holland, Belgium, and others—buy from them in exchange for manufactured articles. Some countries, such as the United States of America, are at once great importers and great exporters both of raw produce and of manufactures; but this condition is somewhat exceptional. Clearly, if the prices of foodstuffs and raw materials fall more than the prices of manufactured goods, the power of the countries which produce the former to buy the latter falls. The standard of living is driven down in the non-manufacturing countries through inability to buy as much as before, while in the manufacturing countries unemployment increases in the export trades owing to the reduction in demand [1]

Thus, the terms on which countries producing primary products and manufacturing nations exchange their products move to the advantage of the latter. Yet, inasmuch as the fall in prices is due to monetary causes and not to greater efficiency of production, we find that our customers overseas buy less of our manufactures and the volume of the export trade falls off. Hence, a fall in prices in an area of primary production reacts quickly on a country like Great Britain, where foreign trade is of great importance.

As yet another illustration of declining purchasing power adversely affecting international trade, we may consider the decline in the value of silver which has so disorganized trade with the Far East. The general trend of silver prices has been in a downward direction for the last sixty years. While, at the beginning of the nineteenth century the ratio of the value of silver to gold was about 1 : 15 and remained very stable up to the seventies, it moved rapidly against silver when a number of countries went over to the gold standard. By 1913 the ratio of silver to gold was in the neighbourhood of 1 : 37, but the decline in the value of gold which occurred during the War stopped this movement, so that in 1920 the ratio was again 1 : 15. In the years which followed, however, silver prices dropped almost without interruption, and between 1920 and 1931 the price of silver dropped from 89d. per ounce to about 15d. Once the principal monetary metal, silver has now fallen to subsidiary importance amongst the gold standard nations. Nevertheless, it retains its eminence as a store of value for nearly half the world's population, since China still uses it for internal currency. In India, although the currency has been stabilized in relation to gold, enormous reserves

[1] G D. H. Cole—*British Trade and Industry*

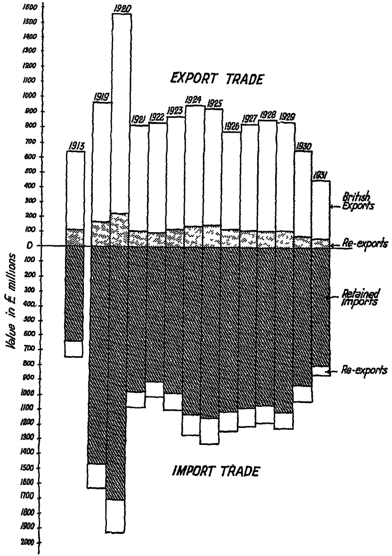
of purchasing power have remained hoarded in silver. The extremely low silver values, and the consequently much reduced buying power of the vast population, are factors contributing to restrict the increase of imports into China from foreign countries. This check to trade may easily become permanent if the currency depreciation lasts over a sufficiently long period. "Finding it increasingly difficult to buy (for payment in gold) goods from abroad, China will be driven to discover ways and means of producing her own requirements. Should she continue to remain on a greatly depreciated silver basis, for some years, it is obvious that she will of necessity not only quickly enlarge her industrial capacity and manufacture goods now made in foreign countries, but will be able to export many of such goods to markets abroad now being served by Great Britain."[1]

Another factor which has in recent times contributed to the dislocation of international trade has been, paradoxically enough, the increase in the world production of commodities. The period during and since the War has been characterized by great developments in productive activity, both in the sphere of primary production and also in manufacture. In the first place, there has been a big development in world production of foodstuffs. In so far as Britain is an importer of this class of commodity, the increase has been mainly to her benefit in that she has obtained her supplies more cheaply. It has led, however, to an increasing pressure from the agricultural interests for Government intervention of some description. The increase in production may be attributed to two causes, namely, the technical progress of agriculture and the disorganization caused by the War.

With regard to the first of these causes, improvements in technical methods, increased yield, and the cultivation of new areas have all occurred in a short space of time. The yield of the land has been increased, not only by the extension of the cultivated area, but also by the adoption of scientific methods, seed selection, the more general introduction of new varieties, the use of fertilizers and heavy manuring, and the employment of machinery. As a result of biological research, for example, wheat is now cultivated in Canada from fifty to one hundred miles farther north than was possible at the end of the War, thus increasing the area which can be brought under

[1] *Report of the British Economic Mission to the Far East*, 1930–31.

Money Value of British Overseas Trade since the War



The above diagram illustrates the fluctuations in the value of British overseas trade since 1919 It will be seen that the money value of both imports and exports rose considerably after the War, but in making a comparison due allowance must be made for the rise in prices. Actually, the volume of exports has remained below pre-war level. The quantity of imports in relation to exports has risen considerably in comparison with pre-war days on account of the fact that the prices of imports have fallen in relation to those of exports so that a given quantity of imported goods can be bought with a greatly reduced quantity of exported manufactures

There has been a great decline in the volume of re-exports which fell in 1929 to about three-quarters of the pre-war amount This decline was due mainly to ... direct trade between the areas producing foodstuffs and

cultivation. Again, in overseas areas of production, the introduction of machinery has revolutionized agricultural methods. Thus, in grain cultivation, cheap traction power is of great importance, and the large-scale introduction of tractors has led to a considerable reduction of costs in many countries. In like manner, the combine—a machine which reaps and threshes simultaneously—has reduced costs of production in regions where topographical conditions are suitable for it.

The economic disorganization caused by the War is painfully clear in the case of agricultural production. During the course of the War there was a considerable development of production in countries outside Europe, and the regular current of trade found new channels. In order to provide food for the belligerents, distant countries were led to increase their production. After the War, when Europe recovered its productive power, these overseas countries were faced with the defensive action of governments desiring to consolidate the position of agriculture in their own countries. The general trend of agricultural effort since the War has been towards the increase of production, whether of crops or of live stock, so that in many cases there has occurred an overproduction of crops, as in the case of certain cereals. Now, when we speak of "overproduction," it must be remembered that we are using the term in a limited, technical sense—

> When it is said that wheat has been over-produced, the meaning is, not that the world has produced more than it needs, but more than the people of the world will buy out of their limited income at a remunerative price. Wheat is scarce in relation to men's needs; but in relation to their incomes it is so plentiful as to have lost greatly in value. For the money valuations men put on things depend on the size of their incomes.[1]

The peoples of the Far East could easily eat the world's surplus of wheat, but their incomes are so low that they cannot afford to buy it, so that no *effective* demand exists for the wheat. Where such overproduction exists, there inevitably arise, sooner or later, schemes for the restriction of supply. These restrictions frequently take the form of tariff barriers designed to protect the home producer against the low prices of his overseas competitors; they may take the form of quota schemes which have the same effect, or producers may

[1] G. D. H. Cole—*British Trade and Industry*.

combine together in some kind of cartel to control prices. All these arrangements have usually one feature in common—they restrict trade, or, at best, force it into artificial channels.

A similar situation has prevailed in respect of industrial raw materials. Here, in the case of several important basic commodities, attempts have been made through monopoly control to keep prices at a profitable level without, except in one or two cases, restriction of productive capacity. In consequence, a period of relatively high prices reduced demand and encouraged substitution, and also increased productive capacity, thus creating an actual or potential surplus capacity. The European coal industry, one of the most important raw material industries, has been subject to a complex set of influences which have tended to restrict demand within surprisingly narrow limits, and to create very considerable local excess capacity. Up to the time of the War, the consumption of coal increased more rapidly than production. Since then technical economies in the use of coal, the increasing use of oil by ships, the development of water-power in various countries, and the general post-war dislocation of industry, have all combined to keep the demand for coal down, whilst the capacity for production has steadily increased. As a result of the suicidal competition between producers, the uneconomic price at which coal has been sold has conferred a substantial bounty on large coal consumers, but at the same time has seriously impaired the financial basis of one of the most important basic industries in the world. The difficulties of the depression have been intensified by the policies of various countries which have attempted to foster domestic production through the medium of preferential railway rates and subsidies, whilst at the same time restricting coal imports from other countries by the adoption of tariffs, licences, and obstacles of a similar nature. Thus the Polish coal industry has captured much of the coal trade of the Scandinavian countries by receiving government assistance through subsidized railway rates.

If we turn to the manufacturing industries we again find a tremendous increase in productive capacity. Taking the world as a whole, the widespread development of home manufactures to meet needs formerly supplied by imported goods is one of the outstanding features of the post-war economic situation. In part, this tendency

is a natural and universal one, inseparable from healthy economic progress, since every area will seek, sooner or later, to develop its latent economic characteristics. Yet, this natural tendency undoubtedly received unhealthy stimulation by wartime conditions and necessities. The cutting off of usual sources of supply and the abnormal demand for certain classes of products for war purposes, compelled many countries, including Great Britain, to embark on the manufacture of goods in respect of which they had hitherto been dependent on importation. Further, the War gave an impetus to the industrialization of certain of the less-developed countries. Manufacturing industries in such countries as Japan, India, and the other British Dominions expanded at a rapid rate, and this continued after the return of peace and more normal conditions of international trade. Such a development has been particularly serious for industries which, like the British textile industry, have had their chief markets in these countries.

The immediate effect of this industrialization of overseas areas has been a restrictive one. Goods which formerly found a ready sale in a particular market are now wholly or partially excluded by the competition of the locally produced article under the protection of an import tariff. Difficulties of this nature have been further accentuated, so far as Europe is concerned, by the creation of new political frontiers. The territorial rearrangements which were considered to be desirable on political grounds have not always produced the economic agreements by which they should have been supplemented. Many existing industrial plants were cut off from their old markets by customs barriers along the new frontiers, behind which new factories grew up and satisfied local demand. Czechoslovakia, for example, inherited more than three-fourths of the Austria-Hungarian textile industry, but the other successor states have promoted new textile industries on their own territory under the shelter of protective tariffs. Again, as a result of its revolutionary policy and the destruction of normal relations between it and other states, the U.S.S.R. has become isolated. In consequence, the Soviet Government has initiated an ambitious plan of industrial and agricultural development which, even though it may not meet with complete success, can hardly fail to exert considerable influence on international trade in the future.

CHAPTER IX

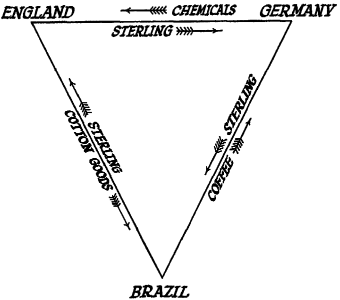
Theory of Foreign Trade

The recognition of the real nature of foreign trade as an institution which is beneficial to all parties is of relatively recent origin. In the seventeenth century the leaders of economic thought had not progressed beyond the idea, which is still unfortunately widely prevalent, that every import signifies a loss and every export a gain, so that the aim of a country should be to import as little as possible and to export as much as possible. In other words, imports should be discouraged whilst exports should be encouraged. Even as late as the eighteenth century, the Mercantilists believed that a transaction which resulted in a gain to one country must inevitably cause loss to another. It was not until the close of the century that the first advocates of modern economic science—David Hume and Adam Smith—gave expression to a new idea, that is, international division of labour.

This term signifies nothing more or less than the fact that the international exchange of goods is regulated by the same principle as that which prevails within a country itself—the principle of the division of employments and the localization of industries. It is to this principle of the division of labour that we must attribute the economic progress of man from the Palaeolithic stage to that of modern civilization. Everyone should confine himself to the production of those commodities for which he is best suited and should exchange these for the products which he requires for his maintenance and well-being. "It is the maxim of every prudent master of a family," said Adam Smith, "never to attempt to make at home what it will cost him more to make than to buy. The tailor does not attempt to make his own shoes, but buys them of the shoemaker. The shoe-maker does not attempt to make his own clothes, but employs a tailor. The farmer attempts to make neither the one nor the other, but employs these different artificers. All of them find it for their interest to employ their whole industry in a way in which they have some advantage over their neighbours, and

to purchase with a part of its produce, or what is the same thing, with the price of a part of it, whatever else they have occasion for. What is prudence in the conduct of every private family, can scarce

TRIANGULAR EXCHANGE



Triangular exchange exists where three or more countries are combined. England, for instance, receives chemicals from Germany and pays in sterling drafts. The proceeds of these sterling drafts are used for paying for coffee received by Germany from Brazil, who, likewise, uses them for settling her account with England for imports of cotton goods from that country The export of Germany to England corresponds to an import from Brazil; the import of England from Germany corresponds to an export to Brazil. From the above diagram it will be seen that the money circulates in the same direction as the hands of a clock and the goods in the opposite direction.

be folly in that of a great kingdom." If a foreign country can supply us with goods cheaper than we can make them ourselves it is better that we should buy them with a portion of the produce of our own industry in which we are superior to foreign countries.

The natural advantages which some countries possess in the production of certain commodities are sometimes so great that, as everyone knows, it would be futile to gainsay them. Adam Smith's famous example of the production of wine from grapes, cited in the last chapter, stresses this aspect. If it would be an obvious folly to invest thirty times as much of the capital and labour of a country upon a particular trade than would be necessary to produce the same quantity of commodities in foreign countries, it must likewise be a folly—though perhaps not such an obvious one—to expend upon such a trade even a fractional portion of capital and labour more than would have to be expended if the article were imported. Whether the advantages which a country enjoys over another be natural or acquired is immaterial. So long as one country possesses these advantages and another country does not, so long will it be more advantageous for the latter country to buy from the farmer than to produce the goods itself. The advantage which an artificer has over his neighbour who carries on another craft is but an acquired advantage, yet both find it more useful to buy from one another than to make those things themselves which do not come within their own calling. The important conclusion is that the division of labour, whether it be national or international, is beneficial to all participants and is, of necessity, a mutual process which creates a bond of solidarity between those who are interested in it. The international division of labour leads to world-wide solidarity of economic interests, so that the good and bad fortunes of the nations are linked together.

INTERNATIONAL EXCHANGE. The principle of international division of labour thus leads us to regard foreign trade as an exchange between countries, which is restricted to the production of those commodities in which the exporting country enjoys superior advantages. This, however, seems to postulate that each of the participating countries must possess an absolute superiority of production in some commodity or other. Let us assume, for example, that we are dealing with trade between England and the United States, and that English textiles are being exchanged for American copper. This exchange postulates that England enjoys superior facilities for the production of textiles, and the United States for the production of copper. In the case of the commodities mentioned

this supposition is probably true, and no doubt the same may be applied to many other goods. This remark applies especially to the exchange of tropical products for those of the temperate zone. If, however, we were to accept this postulate unreservedly a large portion of the foreign trade of the world would remain unexplained. As a matter of fact, international trade is composed to a large extent of goods in which the importing country is actually superior to the exporting country in its methods of production. For instance, there can be no doubt that America with its system of mass production and unrivalled natural resources is superior to European countries in most branches of manufacture, yet the exchange of manufactured goods between Europe and America in normal times is tremendous.

COMPARATIVE COSTS IN INTERNATIONAL TRADE

	LABOUR-CAPITAL EFFORT		
	AMERICA	GREAT BRITAIN	Differential Advantage
GIVEN QUANTITY OF COPPER	10	20	10
GIVEN QUANTITY OF TEXTILES	10	15	5
		$\boxed{18}$	
		Net =	5

In the above diagram, America can produce a certain quantity and quality of copper with labour-capital effort 10 and a certain quantity and quality of textiles with the same labour-capital effort. These quantities will exchange in America for one another The copper that America can produce with effort 10, Britain can also produce, but it will cost her 20 units of effort. And the textiles that America can make with effort 10 Britain can also make but at cost in effort at 15. So, as America would certainly not agree to accept the product of Britain's 15 in textiles for her 10 of copper, there being no advantage to her from doing so, Britain may be supposed to offer as much textiles as she can make with effort 18 in exchange for the copper America can produce with effort 10 And if the bargain is accepted on these terms, America *gains* as many textiles as Britain can make with effort 3, and Britain gets the same amount of copper at a cost of effort 18 as she could make for herself with effort 20, thus *saving* 2 units of effort in satisfying her want for copper. In short, America gains in amount of commodity Britain saves in labour-capital effort

Let us suppose that trade takes place between Great Britain and America in two commodities, namely, copper and textiles, and let us further assume that America is favoured in the production of

both kinds of goods in comparison with Great Britain, but that her superiority is greater in the case of copper than it is in textiles. In such circumstances exchange would tend to take place; the result would be that America would confine herself to the production of copper and would leave that of textiles to Great Britain, so that American copper would be exchanged for British textiles. The obvious reason for this development is that it would be more advantageous for America to concentrate upon the production of that commodity for which it has the greatest *comparative* superiority. Thus, according to the diagram on page 232, it will be seen that America can produce a certain quantity of copper with 10 units of labour-capital effort, and a certain amount of textiles with the same amount of labour-capital effort. These commodities will tend to exchange for each other in proportion to their respective expenses of production. In consequence, this quantity of copper will, in America, exchange for the amount of textiles produced with the same labour-capital effort—whatever the quantities of commodities may be. Now let us suppose that the same quantity and quality of copper that American producers can make with labour-capital effort 10, British producers can make with 20 units of labour capital effort, whilst the same amount of textiles that American producers can make with an expenditure of 10 units of labour-capital effort, British producers can also make, but at a cost of 15 units of labour-capital effort. From these figures it will be seem that although America possesses an advantage in respect of the production of both commodities, she possesses a greater advantage in respect of copper.

Here, then, are two commodities both of which America can produce better than Britain, but nevertheless a trade is almost certain to spring up. British producers will bargain with American manufacturers and will ask for as much copper as they can produce with 10 units of labour-capital effort in exchange for the textiles which the British producer can make with 15 units of labour-capital effort. In such a case the American producer will get as great a quantity of textiles from Britain as he was formerly able to produce for himself, whilst the British producer will receive as much copper from America as he could produce himself with an expenditure of 20 units of labour-capital effort. But it is unlikely that

exchange will take place on such terms since no special benefit accrues to America. The British producer now offers to give as many textiles as he can make with 18 units of labour-capital effort in exchange for the copper which the American producer can make with 10 units. The American producer then gets more textiles for his copper than he could possibly produce with his own labour-capital effort, whilst the British producer receives as much copper as he could produce with 20 units of labour-capital effort in exchange for the product of 18 units of labour-capital effort devoted to textiles. Assuming that this ratio of exchange is adopted, the American producer now gains the product of three British units of labour-capital effort devoted to textiles, whilst the British producer saves two units of labour-capital effort devoted to the production of copper. The American producer *gains in commodity*, whilst the British *saves in labour*. The international bargain splits the difference between the two parties In this case America has gained three units and Britain has saved two units out of the possible dividend of five units of labour-capital effort, which was the net differential advantage resulting from the exchange.

The question which next arises is why is the rate of exchange settled at the above point? In other words, what are the forces which determine the point of equilibrium. Clearly there is only one possible explanation for this. When the product of 18 units of labour-capital effort devoted to textiles exchanges for the product of 10 units devoted to copper, then demand and supply for these commodities are equated on each side. At this point there is no American seeking British goods who cannot get them at that rate, and no British consumer seeking American copper. Supply and demand are in equilibrium on either side. The ratio of exchange, in the case of commodities which are the subject of international trade, depends on the comparative intensity of demand on each side, having due regard for the limits set by comparative cost.

Assuming that the equation of international demand is settled in the foregoing manner, the next question to decide is the magnitude of the demand and supply on each side. In order to explain this we must examine the diagram on page 235. From this it will be seen that before the trade began, American producers used to produce both copper and textiles for themselves as did also the

MAGNITUDE OF FOREIGN TRADE AND ITS DETERMINATION

	AMERICA		GREAT BRITAIN	
Before the trade	COPPER a	& TEXTILES a	COPPER b	& TEXTILES b
After the trade	COPPER a	& COPPER b	TEXTILES a	& TEXTILES b

Before the trade began, America produced both copper for herself (COPPER$_a$) and textiles for herself (TEXTILES$_a$), and Britain produced both copper for herself (COPPER$_b$) and textiles for herself (TEXTILES$_b$) When the trade begins, America ceases to produce textiles for herself and devotes the same amount of labour-capital effort as before to producing copper for Britain, wherewith to persuade Britain to send textiles to her. And Britain, likewise, instead of producing copper for herself, now, at the same expense of labour-capital-effort, produces textiles wherewith to persuade America to send across her copper. So that America's demand for British textiles is seen to consist of exactly the amount of copper that she can produce with the labour and capital set free from making textiles; and Britain's demand for American copper consists of the textiles she can make with the labour and capital set free from producing copper. The demand will not be satisfied on each side unless and until the whole of the copper produced in America with labour and capital set free from making textiles exactly and completely exchanges for the whole of the textiles made in Britain with labour and capital set free from producing copper. The terms of the bargain must oscillate until these exactly exchange.

producers in Britain. If demand is proportionate to cheapness, America will be prepared to devote the same amount of labour-capital effort to the production of copper wherewith to persuade Britain to send the textiles. The amount of copper sent to Britain will equal the product of the amount of labour-capital effort set free from the production of textiles. But it must be remembered that *supply* is only the name for the other party's *demand*. The terms of the bargain will oscillate until all the copper which America produces in exchange for textiles will be equal to all the textiles which Britain makes for America.

In the above example foreign trade between the two countries is based upon the *comparative* costs of production and not upon *absolute* costs. This is the essential fact which has been described by economists as the theory of comparative costs which was first

enunciated by Ricardo in his *Principles of National Economy and Taxation*.

It would be a mistake to infer that the law of comparative cost is confined to the sphere of foreign trade, for the exchange of commodities may develop within a country itself, based upon the comparative superiority in production of one district over another. If one district is superior to others in all branches of production then labour and capital will tend to migrate from the inferior districts to the superior in order to participate in the benefits of production. Yet, even within one and the same country, the factors of production are not so mobile as to bring about a state of equilibrium through migration. In so far as this equilibrium is not attained, an exchange between the two districts in the way we have described in connection with the foreign trade would be beneficial, and the result would be that the superiority in production of one district as compared with the others would reveal itself in a higher level of wages. This difference in the level of wages is due to the marginal productivity of labour. If the factors of production were perfectly mobile, there would be no differences in the productivity of capital and labour and therefore no poorer and richer districts, but only districts with a sparse and those with a dense population.

Although the mobility of capital and labour within a country is by no means unrestricted, this fact becomes still more noticeable when we consider the trade between one country and another. In foreign trade, in the words of Cairnes, we are dealing with "non-competing" groups with regard to the movement of capital and labour, and these factors of production do not flow readily over international boundaries. Let us suppose that a man has a boot factory in Leicester and he is thinking of moving it to Northampton. If he does so, he will notice little change in economic and social conditions. He will find the same laws, the same weights and measures, the same currency and language, and the same trade union rules, so that from this standpoint movement is easy. But should he wish to remove from Leicester to Berlin, his difficulties immediately assume greater proportions. Not only is there the question of the greater distance, but there is a different language, different laws and customs, all of which combine to retard his movement. Thus, although it is not impossible to remove a factory

from Leicester to Berlin, it is far more difficult than removing it from Leicester to Northampton.

It must be admitted, however, that the international mobility of the factors of production has increased considerably since Ricardo first enunciated the theory of comparative cost, but no one would assert that it has become as great as national mobility, and certainly not so great as to render invalid the theory. Large quantities of goods flow through the channels of international trade which could be produced in the importing country at a smaller expenditure of labour-capital effort than in the exporting area. Such commodities are imported because the superiority of the importing country in the production of other goods is greater still.

> The indefinite continuance of such trade thus rests on immobility of labour between countries—on the ties of language, nationality, religion, on the obstacles from ignorance and poverty, which hold people to the land of their birth. Great as is the emigration of modern times, it has not sufficed to put an end to this prevailing immobility. . . In an ideal—and we might call it Utopian—distribution of the world's productive forces, the division of labour and trade which rests solely on comparative differences in costs would not exist But as men and nations are, no small part is played by the great historical gulfs between nations and races and by the resulting immobility of labour [1]

It cannot be too strongly emphasized that wages in one country are higher than those in another because the former possesses a general superiority of production, or a higher marginal productivity of labour, in comparison with the latter. The difference in wages is thus only a manifestation of the conditions under which the exchange takes place. It is therefore fundamentally unsound for the superior country to construe the high level of wages as a danger to its competitive ability, thus feeling itself compelled to protect its wages level by customs duties. The result of such protection is that those branches of production which would be better relegated to foreign countries are maintained within the home country—a fact which depresses the general productivity of the country and therefore the standard of life. It is very important to bear this in mind because it follows that the justification of protective duties cannot be based on the fact that a higher wages level prevails as compared with foreign countries. In this connection, protective duties have

[1] Taussig, *Principles of Economics* (Vol I).

the effect that high wages can be paid in places where they are not sanctioned by a higher economic productivity. The unhampered international exchange of goods in the form of free trade leads to a levelling of prices in the various countries but not to a levelling of wages. These remain high in those localities in which there is a high productivity of labour, and they remain low where the productivity of labour is small. This statement can be verified by a study of the trade between countries with a large difference in wage rates, but which enjoy mutual freedom of trade; for example, in the trade between Great Britain and India before the War.

We will now endeavour to summarize the results of the foregoing considerations. In the first place it must be noted that international trade is based upon territorial division of labour. This means that foreign trade would not be carried on if it did not appear advantageous to each of the participating countries. Such exchange is of advantage even for those countries which possess a superiority of production in respect of all the goods which are the subject of exchange, whilst the exporting country may posses inferior facilities for the production of these commodities—assuming always that there is a difference in their *comparative* costs. Thus there would be no trade between the United States and Great Britain in the following case because there is no difference in relative efficiency—

Units of labour-capital effort required to produce a given quantity of	United States	Great Britain
(a) COPPER	$\boxed{10}$	20
(b) TEXTILES	10	$\boxed{20}$

From this it will be seen that trade arises because of the comparative advantage and not on account of the absolute advantage. All international trade is a process of splitting the difference caused by relative costs; so much so, that if there were no difference to split, there would be no trade. This is illustrated by the above case in

which the United States has the same absolute superiority of production in regard to both commodities The benefits of exchange are the same for all countries in that the exported goods are cheaper than they would be if produced in the country of importation. This relative cheapness of exports may arise from a number of causes—

> It may arise from climatic superiority or other natural fitness, or from skill and aptitude due to complex human causes, or it may arise from a combination of these. The advantage of the United States in wheat, and its exports of wheat, rests (or rested) partly on the possession of vast tracts of new and fertile land; but it was much promoted also by the intelligence of its farmers and their large use of agricultural machinery, and by cheap rail transportation from the western wheat-fields to the seaports. All sorts of causes here concur. not only the obviously natural ones, but those connected with land tenure and land ownership, with universal education and universal ambition, with the influence on freight rates of unfettered enterprise, of private construction and management of railways [1]

It must also be noted that goods are sometimes imported from abroad which are exported as domestic products and may be produced in large quantities in the home country. This may arise because the foreign producing centre is nearer to the home consuming centre than the home producer or, at all events, because the costs of bringing the goods to market are smaller from the foreign centre than from the home centre of production. Thus rye is exported from East Prussia to the Scandinavian countries whilst it is also imported from Holland and Belgium into the industrial districts of the Rhine. Again, where goods are imported in face of a large home production, the explanation may be due to the fact that if the home demand were to be met completely by home grown supplies, the cost of production would rise in accordance with the law of diminishing returns.

In conclusion, we have to inquire how the benefit which arises from international trade is distributed amongst the parties to the exchange. Is it distributed equally, or is it distributed in such a way that the advantage of one country is greater than another? Obviously the advantage resulting from foreign trade will be the greater the less a country has to give of its own products in order to acquire a certain quantity of goods imported from foreign countries;

[1] Taussig, *Principles of Economics*, Vol. I.

that is, the cheaper it gets the goods imported. This relationship is described as the *equations of international demand*, and it may be said that the benefit to one country is the greater the more favourable the equation of international demand, or in other words, the higher the price of the exported goods and the lower the price of the imported ones. The benefit to Great Britain of her export trade with the Argentine will increase, the smaller the amount of machinery, textiles, and other manufactures we have to give for a certain quantity of Argentine wheat.

In normal circumstances it is probably true to say that the terms of exchange depend upon the relative demands of the participating countries for the goods of others. It may happen, however, that the terms of exchange may move in favour of a country for other reasons, as where a fall in the general level of world prices affects more seriously the prices of primary products than those of manufactured goods. In consequence, the normal relationships between agricultural and manufacturing countries tend to be seriously disturbed. For example, in 1928, by shipping to this country a ton of cereals, a foreigner could obtain in exchange some 55 yards of woollen tissues. In 1931, notwithstanding a reduction of over 50 per cent in the cost of raw wool, the same quantity of grain exchanged for less than 30 yards of woollens. Grain was coming into the country more cheaply, but since this cheapness was due to arbitrary fluctuations in the value of money and not to greater efficiency of production, the foreigner was unable to produce sufficient grain to find a market and purchase the former quantity of woollen goods. The result was that two out of every five woollen operatives in employment in 1928 were out of work in 1931. A similar result followed in other branches of production. Exports of manufactured goods to the impoverished countries dependent on primary products declined heavily, and employment declined in the export industries in manufacturing countries.

TEST PAPER 9

1. International Trade has been described as "division of labour between nations" Bring out the significance and estimate the correctness of this description.

2. State the economic reason why Britain is becoming less and less an agricultural nation, although there is an abundance of uncultivated land in the country.
3. State how you personally are interested in the extension of British trade abroad, even with countries you seldom hear of, and in articles which you yourself never use
4. The Mercantilists are charged with having fixed attention on the accumulation of treasure within the country Is this account of their policy just or complete? By what means and with what success did they seek to carry out their "system" in practice?
5. "In matters of trade the whole world is as one country in which nations are like persons" How far is this account given by an old writer illuminating or misleading, in theory and in practice?
6. Show what fundamental advantages nations derive from international trade, and apply your general exposition to the particular case of trade between a nation economically "new" and a nation economically "old."
7. Point out the advantages and difficulties of trade between different countries as compared with trade within a single country.
8. "Nations will not begin trading with one another to any extent unless comparative values differ." Explain fully the doctrine thus enunciated.
9. Under what conditions in pure theory will foreign trade arise between two countries? What factors will determine which of the two countries will derive the greater advantage from the exchange?
10. How would you measure the benefit which a country derives from its Foreign Trade? Discuss what is meant by the Principle of Comparative Cost, and show how it determines the nature of imports and exports.

CHAPTER X

The Balance of Trade

The simplest form of foreign trade is that in which the primary producer and the ultimate consumer enter into direct relationship with each other. At the present time, however, this method is rarely encountered even in the home trade, and it is even more uncommon in the case of dealings with foreign countries. Here, in the case of most classes of commodities, we find intervening between primary producer and ultimate consumer a more or less lengthy chain of middlemen, who undertake certain specialized duties in connection with the movement of goods. The rise of these middlemen, although due to many causes, may be explained in general terms as being due to the great distance between the parties, the difference of language, the existence of unusual risks, the difficulties of advertising, the diversity of currency systems, as well as to the need for specialized knowledge of merchandise and of customers. Hence a group of specialists has gradually developed in connection with foreign trade, in the form of agents, brokers, warehouse-keepers and others.

The organization of this trade varies with the nature of the commodities, according as to whether they are raw materials or finished goods, and also, in a certain degree, according to whether we are dealing with the import or the export trade.

RAW MATERIALS. The trade of the world in respect of raw materials is closely connected with the produce exchanges on which staple commodities are bought and sold in accordance with the regulations of the exchange. The chief produce exchanges are to be found in the great ports: for example, Chicago, Winnipeg, London, or Liverpool for wheat; London for tea, wool, and dried fruits; Liverpool, Bremen, Le Havre, and New Orleans for cotton, and so on. The dealing in these commodities is of a more or less standardized nature and, inasmuch as they are mostly staple commodities in constant demand, the marketing problem associated with them is to that extent simplified.

MANUFACTURED GOODS. In the case of manufactured products we find no such degree of standardization as will warrant the introduction of produce exchanges, for manufactured goods are two numerous and individualized for their sale to be concentrated in centralized institutions. Moreover, the commercial technique is much more complicated in the case of manufactured goods. The export of manufactured goods is effected in one of the following ways—

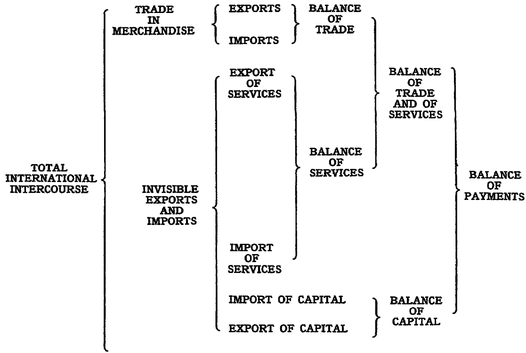
1. **Direct Exportation by Manufacturers.** The makers of the goods may establish their own branches and connection in overseas markets. This method is particularly desirable where close contact with customers has to be maintained in order to adapt the product to their needs. In some cases, a number of manufacturers either in the same or in allied trades may combine to form an export sales agency for the same purpose.

2. **Specialized Exporters.** The work of selling in overseas markets may be relegated to specialized firms of exporters by the manufacturers. Thus we have firms of cotton merchants and coal exporters who possess special knowledge of markets and commodities In recent years many of these firms have tended to lose ground in favour of direct exportation.

3. **General Exporters.** These are exporting firms which do not specialize in any particular class of goods, but are prepared to obtain anything which their customers may require. This class of undertaking may confine its attention to a definite area, such as the Far East, the Baltic, or South America. Such general exporting firms are becoming of smaller importance with the development of direct exporting by manufacturers.

From the foregoing it may be gathered that international trade is concerned with the exchange of values, whether these values are connected with material commodities or intangible services. We may sell our manufactured goods overseas, but we can also sell the services of our shipowners in carrying freight, or the services of our banking and insurance system in providing the finance or in safeguarding traders from the risks associated with property. It is with these movements of value to and from a country that we shall be mainly concerned in this chapter.

BALANCE OF TRADE AND BALANCE OF PAYMENTS



TRADE IN MERCHANDISE. The trade in material commodities is, of course, the most obvious form of international trade—so obvious indeed that there are many who would appear to imagine that it constitutes the beginning and end of foreign trading relationships. In Great Britain this trade in material commodities is of the greatest importance even though, as we shall show later, it by no means accounts for the whole of our international trading transactions. As one writer has very aptly pointed out, Great Britain may be compared with one of our great cities. "Like a city, it must obtain supplies from without and pay for them either by goods produced within its frontiers or by services which can be exchanged for goods. Moreover, the production of goods implies raw materials, and these again must as a rule be imported from abroad. In short, apart from that section of its people employed in agriculture or mining, or in carrying the products of these industries, Great Britain is merely a gigantic urban area, dependent for its very existence on the supply of food and raw materials from without, and these are purchased largely by the products of its manufacturing industries."[1] Hence, this movement of commodities both inwards and outwards is a matter of the greatest significance in the economic life of this country. We may consider this trade under the following headings—

1. Import Trade. Broadly speaking we may say that the most important elements in the British import trade are the importation of foodstuffs and of industrial raw materials. Imports in the first category, described in the official returns as imports of food, drinks and tobacco, are by far the most important. In 1931, for example, when commodities of this class could be purchased at exceptionally low prices, we spent more than £400,000,000 on them. In respect of certain important classes of products such as grain, meat, dairy produce, and fruit, although a certain amount of home production occurs, comparative costs of production keep it in a subordinate position. In consequence, despite trade restrictions and tariffs, the British market is likely to remain the most important in the world in respect of goods of this class

Not only do we depend upon importation to furnish us with the necessary foodstuffs to feed our dense population, but we also rely

[1] Professor A. J. Sargent, *British Industries and Empire Markets.* (E.M.B. 26)

upon overseas sources of supply to provide us with the raw materials to give them employment. With the exception of coal and possibly to a smaller extent, iron ore, we are almost completely dependent upon the import trade for our supplies of such important materials as non-ferrous metals, cotton, wool, silk, timber, rubber, hides and skins, and similar commodities. Again, in the third class of imports recorded in the Board of Trade returns—Articles Wholly or Mainly Manufactured—certain of the more important imports serve as raw materials for important British industries, such as crude iron and steel, copper, lead, tin and zinc. In addition to these, oil, the basis of the motor transport industry, figures importantly in the total.

These different classes of imports react differently to changing conditions of world trade and the position of domestic industry. The quantity of foodstuffs purchased will remain relatively stable in periods of good and bad trade since in times of depression the population must be fed whilst in more prosperous days it will not require to eat more—man's appetite does not expand with his income. Nevertheless, the direction of his expenditure may vary considerably, for in times of good trade he will purchase more expensive varieties of food, whilst in a period of depression he falls back upon the staple articles of diet. Thus, in the course of the world depression of 1929–32, imports of wheat and beef were maintained, whereas sugar showed a decline. In the case of industrial raw materials, however, we have a more direct correspondence with the state of trade, for a slackening of business soon causes a decline in the demand for materials which reflects itself in the composition of the import trade.

2. Export Trade. With the outstanding exception of coal, the export trade of Great Britain depends mainly upon manufactured goods. As already pointed out, the principal raw material of economic importance produced in this country is coal, which has served as a basis for our manufacturing industries as well as a large export trade. In recent years, however, the value of this trade has suffered a very serious decline owing to development of rival producing areas abroad and to restrictions on trade. This export trade in coal has, in the past, played a very important part in the economy of this country. It has furnished our shipping with an outward

cargo to all parts of the world, thus enabling return cargoes of raw materials and foodstuffs to be brought to our shores at a minimum of cost. The diminution in the volume of this trade since the War has lessened this advantage

The most valuable part of our export trade is, however, made up of manufactured goods in the production of which we utilized the raw materials and semi-manufactured goods brought from other countries. Many of the most important British manufacturing industries, such as iron and steel, engineering, textiles and clothing, have been built up on the basis of an extensive overseas demand. Since the War this trade has been carried on in the face of increasing difficulties, particularly as regards the cheaper classes of goods. Most overseas countries have attempted to develop local industries and have protected them behind tariff barriers so that extensive markets have been wholly or partially lost. The expansion of the British export trade offers one of the most urgent problems of the present day since a permanent decline in this trade can result only in a lower standard of living for our people.

3. Entrepôt Trade. This trade, which is of considerable importance to Great Britain, consists of—

(*a*) The importation of goods which are not intended for home consumption but only for further treatment, and the re-export of those goods after they have been subjected to some process of manufacture. In this respect it is immaterial whether this process of manufacture is carried out at the expense of the home country or for foreign account. For example, foreign wheat may be imported into London for the purpose of being converted into flour and is then re-exported in its finished state.

(*b*) The exportation of raw and partly-finished materials with the object of having them finished in a foreign country and then re-importing them after they have been finished abroad. Thus, textile fabrics may be exported with the object of having them bleached, dyed, and finished abroad.

4. Transit Trade. In this category we may include the shipment of commodities to this country for re-distribution abroad without any manufacturing operations of any descriptions being performed upon them. The fact that this country formed such a large market for raw materials and foodstuffs has frequently led to the establishment

of specialized machinery and institutions for dealing in commodities. In consequence, the overseas producer has found it most convenient to send the whole of his output to this country and allow it to be redistributed from London or some similar centre. In this way, both producer and foreign buyers could avail themselves of our special facilities. In recent years, however, this class of trade has showed a decline, partly owing to the establishment of rival markets in the centres of consumption, and partly on account of the increase of direct sales in producing areas. Thus London has for many years been the world's principal market for raw wool, especially for the better grades. Yet, for some time, and particularly since the War, its importance has been declining. There has arisen the practice of shipping wool direct to such ports as Hull and Liverpool, which are near to the consuming centres. Again, local wool markets have been established in Australia and in New Zealand, and these have handled an increasing volume of business since the War.

INVISIBLE IMPORTS AND EXPORTS. The relative position of the imports and exports of commodities, however, can tell us little or nothing about the economic position of a country. We have to give consideration to the fact that the inhabitants will have some income derived from sources other than those directly connected with the sale of merchandise in overseas markets. The nature of this income and, in consequence, the relationship which exists between commodity imports and exports, will vary from one country to another, and may be expressed as the resultant of the way in which the inhabitants of a region decide to specialize their labours, spend their income, and invest their savings. Just as individual persons derive their incomes from a variety of sources according to their specialized callings, so do those aggregates of individuals which we term nations obtain income in numerous different ways.

The small tradesman, with no resources outside his own business, derives an income from his dealings in commodities. In this case we know that, in the long period, his business purchases and expenses together with his housekeeping expenditure, cannot exceed the value of his sales. On the other hand, if he runs a motor haulage business as a side-line, then it will be evident that the outcome of his dealings in goods in his shop will offer us a very unreliable indication

of his financial position. His sales may amount to £5,000 a year, and his purchases and business expenses come to £4,500, leaving him with a "favourable balance" in respect of his trading activities of £500. If, however, we find that he has adopted a scale of living which costs him £1,000 a year, we cannot legitimately say that he is living beyond his means until we know what revenue is being obtained from his haulage business.

The professional man—the lawyer or the doctor, for example—sells no material commodity, but only intangible services, yet, in exchange for his skill, he may command a substantial volume of goods and services from others. Finally, the fortunate possessor of large capital investments may sell neither goods nor services in order to obtain an income He may rely simply and solely upon the revenue from interest and dividends to provide him with the means to command the goods and services which he requires. Just as individual persons may derive an income from a variety of sources —such as by trade in commodities, rendering services, or from interest on investments, so the income of the nation from external sources shows similar diversity in its origin. We have already considered the trade in commodities, so that we now must turn our attention to the income derived from investments and services.

For a long term of years now, the inflow of commodities into the country has been far greater than the value of the outflow. This surplus must obviously be paid for in some way unless we are prepared to assume that certain philanthropists abroad are making us a present of a large volume of goods. In a world which operates an international gold standard, the difference could conceivably be made good by an exportation of gold bullion, but a balance which was persistently adverse could not be corrected by this means. It was on this ground that the early writers on foreign trade showed such concern as to the relative position of imports and exports A preponderance of imports over exports would lead to an outward "drain" of gold and silver bullion to pay for them, whereas a surplus of exports over imports would have the converse result. Then followed a time when the belief in the virtues of an accumulation of bullion began to be questioned, and it began to be realised that factors other than commodity movements determine bullion movements and the state of the trade balance. Yet old superstitions

die hard, and it was found convenient to explain the predominance of imports by bringing in what were termed "invisible" imports and exports to redress the balance. Thus—

> The public was led to believe that, though recorded imports and exports did not balance, there were unrecorded or "invisible" imports and exports in addition, which when added into the account, would make it balance To treat various services rendered as unrecorded imports and exports, the value of which should be added to that of the recorded imports and exports, and called "invisible" imports and exports, was defensible. But it was quite absurd to call the registration of a person's name as an owner of colonial or foreign stock, or even "scrip" issued to owners of colonial and foreign bonds, an "invisible import" counterbalancing the export of locomotives and rails bought with the loan [1]

Hence, this concept although it is capable of removing certain difficulties, may create others unless applied with caution. The term *invisible exports* is employed to denote those obligations and services for which payments have to be made to a country, that is, they have precisely the same effect as the export of commodities. Thus, when travelling expenses are incurred in England by a foreigner, the economic effect is the same as that produced by the export of goods—value is brought into the country. Conversely, any obligations or services for which a country has to pay are termed *invisible imports*, since these have the same effect as an import of goods, that is, value is exported to a foreign country in exchange.

It is, of course, quite out of the question to obtain records of these "invisible" items in the same way and with the same accuracy as commodity movements are recorded. By indirect methods it is possible, however, to form an estimate of the values involved. One of the first attempts to assess the elements entering into the balance of payments was made by Sir Robert Giffen in 1877, and, with the exception of 1921, the Board of Trade has published estimates for every year since 1920, as well as for 1913. We shall now examine the various elements which form the basis of the figures issued by the Board of Trade.

1. Receipts and Payments on Government Account. This consists of the excess of receipts over payments in respect of government transactions. Receipts and payments in respect of loans between

[1] Professor Edwin Cannan, *Balance of Trade Delusions*. Sidney Ball Lecture, 1931.

UNITED KINGDOM BALANCE OF PAYMENTS ON INCOME ACCOUNT

(£ millions)

Particulars	1928	1929	1930	1931
Excess of Imports of Merchandise and Bullion	358	366	391	376
Invisible Items—				
Estimated Excess of Government Receipts from Overseas	15	24	19	16
Estimated Net National Shipping Income	130	130	105	80
Estimated Net Income from Overseas Investments	270	250	220	165
Estimated Net Receipts from Short Interest and Commissions	65	65	55	30
Estimated Net Receipts from Other Sources	15	15	15	10
Total of Invisible Items	495	484	414	301
Balance[1]	+ 137	+ 118	+ 23	− 75

[1] (+) Favourable, (−) unfavourable.

The above table shows the British Balance of Payments on Income Account as computed by the Board of Trade. The figures are subject to a wide, and somewhat uncertain, margin of error, the most accurate probably being that connected with commodity movements. From the trend of the figures it will be seen that the "invisible" items have been the ones most seriously affected by the depression of trade. The Hoover Debt Moratorium of July, 1931, was responsible for a decline in Government Receipts, but the heavy burden of loss fell upon the following three items. The most serious decline has occurred in respect of income from overseas investments, particularly that portion of the revenue derived from trading companies. The problem of the adverse balance in 1931 resolves itself into a problem of stabilizing world economic conditions in such a way that our overseas investments can once more yield a profit for the benefit of the shareholders in this country. Any attempts to "correct" the balance on commodity account leaves this question unsolved, and indeed renders its solution much more difficult if not impossible.

Governments, reparations receipts, and receipts on account of Indian home charges form the chief elements under this heading. Receipts on account of Indian debt and interest on Indian railway capital are not included, but appear with the income from foreign investments. Of smaller importance are receipts on account of the overseas activities of various public departments such as the Admiralty, or the Diplomatic and Consular Service. In computing this figure, only receipts which originate overseas and payments

made overseas are taken into account. Thus, the value of stores sent from home and the cost of sea transport paid from United Kingdom funds are excluded.

2. Net National Shipping Income. Great Britain, in her capacity as the "world's carrier," performs shipping services for other nations on a very extensive scale. In attempting to assess the value of these earnings, it is to be feared that the official computations rest upon a basis of conjecture rather than upon ascertained fact. The figures of commodity imports are taken upon a c.i.f. basis so that they include not only the value of the goods in the country of origin, but also the costs of bringing them into a British port. Now, quite a large proportion of these goods are brought in British ships so that a considerable amount which is counted in the merchandise imports as being due to foreigners is actually due to British shipowners. Again, exports of goods are valued on an f.o.b. basis, that is, no allowance is made for insurance and freight to the country of destination. Hence, to the extent to which such goods are carried in British-owned ships, the amount of the claims on the countries receiving the exports is under-estimated. In placing a value on the services of British shipping, it has been found most satisfactory to leave the trade entries as they stand and to make a separate calculation of the gross earnings, including earnings on trading between foreign ports, passenger income, and the remuneration for other services by shipowners. From these gross earnings there must be deducted shipowners' disbursements in overseas ports for wages, fuel, stores, port dues, etc To the net earnings thus obtained it is convenient to add the amounts paid by foreign ships in United Kingdom ports for bunkers, stores, port dues, and other expenses, the resultant figure being described as the net national income from shipping services.

An examination of the figures given in the table on page 251 will reveal the serious decline which has occurred in respect of this item in recent years. The causes of this decline are not far to seek The world-wide dislocation of trade caused by monetary disorders and a vicious policy of tariffs has found an immediate reflection in the demand for shipping. It is obvious that when the nations are applying all their energies towards checking the movement of goods over national frontiers, the demand for the service of transport must

be seriously curtailed. But the decline in goods transport has been but one aspect of the problem, since passenger services have also suffered. Writing of conditions in 1931, it was said that—

> The passengers in British ships to and from non-European countries were about 25 per cent fewer than in 1930, the smallest proportionate decline being shown in respect of first-class passengers, while the number of passengers travelling to and from the Continent showed a decline of about 9 per cent. Reductions in fares will have affected the earnings of British shipping from passenger traffic to an appreciable extent and the figures indicate a reduction in 1931 of about one-quarter of the total receipts from the carriage of non-resident passengers [1]

The decline in freight rates has affected all classes of shipping The decline in the demand for shipping services would in itself have brought this about, but the fall has been intensified by yet another cause. Immediately after the War a large amount of new tonnage was constructed to cater for the boom conditions, and this was accentuated by Governments giving financial encouragement, either in the form of state-owned ships or in the form of subsidies. At the present day, as a result, there is in existence a large surplus of shipping. Shipowners find freights forced down to a pre-war level, whilst operating expenses remain much higher. In view of our large interests in shipping, much of the burden of loss falls upon the British shipowner.

3. Net Income from Overseas Investments. Under this heading is included all income from overseas investments, whether of a joint-stock or private character, and the figures given allow for the deduction of income paid to overseas residents in respect of their investments in the United Kingdom. Furthermore, they do not include receipts and payments between Governments in respect of war debts settlements, which have already been considered As was pointed out in the Macmillan Report, the official estimates of this large item in our invisible exports have been subject to disconcertingly frequent and large revisions after publication. The basis of the figure appears to rest upon the results of the investigations of Sir George Paish in respect of British investments overseas for the years 1908 and 1911, supplemented by the more recent work of Sir Robert Kindersley. The following notes summarize the most recent investigation.

[1] *Board of Trade Journal*

In an article contributed to the *Economic Journal* for September, 1931, Sir Robert Kindersley gave the results of an inquiry into British foreign investments in 1929. He stated that—

The investigations undertaken cover British investments in the bonds and stocks of foreign and colonial Governments and Corporations, interest payments on which are made in London, and in the securities dealt in on the London Stock Exchange of companies, both British and foreign, operating abroad. The whole field of British foreign investment is therefore covered with the exception of (1) individual private investments, (2) companies operating abroad whose securities are not officially dealt in here, (3) the bonds and stocks of foreign Governments not quoted here For example, although it is seldom the practice of residents in the United States to subscribe to the sterling portion of a loan issued both in London and in New York, British nationals frequently subscribe for or purchase large quantities of the dollar portion of such an issue. There is also a large and increasing investment by our nationals in United States securities issued and quoted only in New York, largely owing to the increasing activities of the agencies of United States banks and bond-selling houses in London

The results of the investigation were summed up in the following statement—

TABLE SHOWING THE DIVISION OF BRITISH CAPITAL INVESTED ABROAD AS BETWEEN LOAN AND SHARE CAPITAL, AND THE INCOME DERIVED FROM EACH CLASS IN 1929

(£000's)

Group	Share Capital	Dividends	Loan Capital	Interest
	£	£	£	£
1. Foreign and Colonial Governments and Corporations	—	—	1,412,425	64,661
2 Companies registered in U.K and operating abroad	801,605	67,674	385,206	18,309
3. Companies registered and operating abroad	436,002	41,997	402,786	19,724
Total	£1,237,607	£109,671	£2,200,417	£102,694

From the above statement it will be seen that the field of investment examined covered £3,438 millions of British capital. After making allowance for those items omitted from the survey, it is probable that this total should be written up by about £300 millions, making the amount of British overseas investment about £3,738 millions. The figures given above reveal that "in spite of the fact that debentures and other forms of loan capital constitute nearly two-thirds of British capital overseas, yet dividends on share capital averaging 8 86 per cent amounted to more than half of the total income from these investments in 1929. If in a bad year average dividends decline, say, to 3 per cent, then assuming no default in debentures, it is clearly possible for our income from overseas investment to fall to as low a figure as £140 millions."

As will be seen from the official figures given in the table on page 251, we have now had first-hand experience of the decline in our overseas investment income which can occur in a bad year. Defaults in the payment of interest by foreign Governments have not had quite such a serious effect upon our position as is sometimes stated—indeed, it is thought that from 80 to 90 per cent of the fixed interest payments due to Great Britain from abroad, excluding war debts, were paid in 1931. The number of government defaults in the world in general was, however, disclosed in a report of the Foreign Policy Association which showed that, whereas in 1929, only one of all the government loans listed on the New York Stock Exchange was in default, by the end of 1931 the number had reached 49. The arrears of interest, excluding any amounts due from Russia was about $1,100,000,000. It is, of course, difficult to assess the amount of this loss which has fallen on the British investor.

The most serious loss was occasioned, however, by the serious reverses suffered by industrial and trading undertakings in which we are interested. Thus, dividends from railways were substantially reduced, as were also dividends from mines, rubber, oil and tea producing companies. The great majority of such concerns made no profits, and were even a drain on our resources through having to draw on London reserves built up out of previous profits.

4. Receipts from Short Interest and Commissions. Income under this heading is received in respect of London's banking, insurance, and stock exchange services. Important sums are received in this country in respect of services rendered to persons resident abroad, such as charges on acceptance credits, discount on foreign bills, commissions and other charges on new issues paid by overseas borrowers, and merchanting commissions on overseas produce Deduction has to be made in respect of payments made to foreigners for similar services. Once again we find ourselves handicapped when we attempt to fix a value to these various services. The Macmillan Report urged the collection of much more detailed information by the Bank of England in respect of such items as the magnitude of foreign balances and the aggregate of acceptances on foreign account, which would offer more reliable data for the computation of this important figure

A source of revenue of growing importance under this heading is

that of insurance. The insurance institutions of Great Britain enjoy a reputation which is second to none, because a British policy is the highest security known In the United States, for example, since the San Francisco disaster, when every British insurance office paid in full and some American offices did not, we have enjoyed a large measure of American confidence. It has been said that—

> British insurance institutions enjoy a world reputation which nothing has yet been able to diminish. From every quarter of the globe insurance pours into London in an ever-increasing quantity. We export insurance to every country under the sun and receive in payment countless millions of francs, marks, florins, kroner, yen, and dollars. This export does not depend upon our internal prosperity, it depends upon a unique reputation which our insurance institutions have earned of meeting their obligations generously, promptly, and always [1]

Moreover, it is possible for this business to prosper in spite of depressed trade. Its trading profits are not dependent upon the fortunes of the factories insured, but upon their freedom from fires, the avoidance of accidents to workpeople, and so on. This is not to say, of course, the depression of trade has no effects upon insurance, but there is not such an immediate connection as is to be found in other branches of business.

5. Receipts from Other Sources. This item represents the balance of receipts over outgoings on account of the sale and purchase of second-hand ships, emigrants' remittances, the savings of emigrants returning to this country, and tourists' expenditure. Except with regard to the sale and purchase of second-hand ships, information in respect of the various receipts and payments is scanty, and the figure given is purely conventional. In any case, the amount is comparatively small. Tourist expenditure, for example, is small in this country as compared with some foreign centres. Thus, in France, in normal times, the total benefit to the French national income from the spendings of all foreign visitors has been officially estimated by the French Government at £120,000,000 a year.

MOVEMENTS OF CAPITAL. We have so far been concerned with what is usually termed the Balance of Payments on Income Account, which deals with items of a revenue character. In order to complete our examination we must, however, give consideration to

[1] *Manchester Guardian Commercial*

movements of capital, including foreign loans which are made or repaid, and the sale or purchase of securities and other capital assets between foreigners and nationals. Indeed, these movements of capital may become so important as to overshadow changes in current income, as was the case in Great Britain in the middle of 1931 when the drain on London's resources forced this country off the gold standard.

A country with a favourable balance of payments on income account may elect to receive that balance in the form of commodities, including gold. Alternatively, it may invest that surplus abroad in the form of loans, or in shares in industrial and commercial undertakings, or as short-term obligations Now, in pre-war days, this overseas investment usually took the form of long-term lending, and when capital sums fell due for repayment, they were usually re-lent, either in the same or in other countries. Since the War, however, there has been a much greater reluctance to sink capital in long-term loans, and there has been a large increase in the proportion of total loans made on short-term account. This development has been due largely to the lack of confidence which created a desire among the investors of many countries to keep a large proportion of their funds in liquid form. In these circumstances, such funds could readily be moved from one centre to another if their safety were threatened. Moreover, the development of Paris and New York as centres of international finance has caused changes in the nature of long-term lending. Although both centres possess ample funds for investment, they have been under no immediate necessity to maintain a steady flow of capital overseas. In consequence, many borrowing countries found that their wants were being satisfied spasmodically, and frequently on unsatisfactory terms. The result has been that a new factor of uncertainty has entered into international balances of payments.

Turning now to the special case of Great Britain, the monetary policy since the restoration of the gold standard in 1925 had been such as to create a position of instability. According to the view of Mr. J. M Keynes—

> By the return to the gold standard in 1925 at an unsuitable parity, the Bank had set itself a problem of adjustment so difficult as to have been well-nigh impossible On the one hand, it was obviously impracticable to enforce by high Bank Rate or by the contraction of credit a

deflation sufficiently drastic to bring about a reduction in internal costs appropriate to the parity adopted On the other hand, the maintenance of a low Bank Rate, which would have rendered London unattractive to foreign short-term funds, would, in the actual circumstances of our trade balance and of our readiness to lend abroad, have led to a rapid loss of gold by the Bank and a much earlier collapse of the gold standard. . . But the policy actually adopted was to preserve a middle course —with money dear enough to make London an attractive centre for foreign short-term funds, but not dear enough to force an adjustment of internal costs.[1]

The direct consequence of this policy was that London attracted an abnormally large volume of foreign short-term capital, which has formed the basis of an international deposit banking business. Yet, inasmuch as the New York money market has developed along similar lines, there was a ready opportunity for this liquid capital to move easily from one centre to another. Hence, an increase in interest rates in one centre may cause embarrassment in both on account of the capital movements which are set in motion. One centre loses capital and may be subjected to serious strain in consequence; the other finds itself in receipt of short-term funds which it may consider undesirable since its liabilities to the rest of the world are thereby increased. As the Macmillan Committee pointed out, "the ease with which we can for a time meet claims on us by attracting precarious short-term deposits, while it is certainly a great convenience, may also be a danger unless we avail ourselves of it only with the greatest moderation and prudence." The Committee discovered that our short-term capital liabilities to foreigners amounted to about £450,000,000, but subsequent events revealed that this figure understated the position. When it is stated that the liquid assets which London could mobilize at short notice did not amount to one-third of this liability, the extreme instability of London's position may be realized.

The demands made upon London for long-term finance had increased relatively to the annual surplus available. Yet, on account of the presence of these short-term funds we were able to continue lending abroad on a scale not far short of that prevailing before the War. It is to this fact, and not to the "adverse" balance on income account that the difficulties of London in September, 1931,

[1] "Reflections on the Sterling Exchange," *Lloyds Bank Review*

were due. In the same year it was clearly demonstrated in the case of Germany that where confidence is lacking and the country owes a large sum payable at short notice, withdrawals of capital may take place on an immense scale, even in a case where the current balance of trade is positive. In the case of Great Britain, movements of capital took place on such a scale as to obscure the unfavourable balance on income account, so that between June, 1931, and February, 1932, she may have repaid anything from £300,000,000 to £400,000,000 of her capital liabilities In the face of such figures it is misleading in the extreme to attempt to draw deductions from the balance of payments on income account and ignore capital movements.

MECHANISM OF THE BALANCE OF PAYMENTS. Apart from these important transactions in capital, we may say that in the last resort, goods and services are exchanged against goods and services. The various debit and credit items in the balance of payments on current account must balance, *but it is the items as a whole which* must balance, not individual cases. What we have to explain is the method whereby this balance is brought about. Let us assume, by way of example, that a person in England buys a French motor-car. Payment might be made in terms of either English or of French money. In the former case, the French motor manufacturer will have the right to so many pounds sterling, but this right will be of little value to him inasmuch as he has to meet his expenses in terms of francs. In other words, he will wish to find someone to whom he can transfer his claim in pounds sterling in exchange for the equivalent value in francs. In other words, he must find someone who wishes to settle a debt in England and is in a position to purchase the requisite sterling with francs. If, however, the English purchaser of the car pays in francs, then he must find someone with a claim to francs who is willing to sell that claim for sterling. In actual practice, of course, we know that importers and exporters do not buy and sell claims to foreign currencies direct with one another —the banking system intervenes to save this trouble—but international dealing is rendered possible only by the existence of this complicated network of claims and counter-claims. It is, of course, open to the seller of the French motor-car to invest the proceeds of the sale in England at interest. But in this case he will ultimately

be confronted by the problem of obtaining payment of interest and, subsequently, the repayment of his capital.

By importing goods, Britain gives to foreigners purchasing power in Britain, by importing more she increases their purchasing power, by importing less, she decreases it Because foreigners have more purchasing power, it does not follow automatically that they will then and there purchase more goods and services, they may exercise their power to take gold or they may forgo its exercise and make loans, either at call or for a definite period. Because foreigners have less purchasing power, it does not follow automatically that they will then and there buy fewer goods and services; they may need the goods and services so badly that they will send gold or will borrow, and will find Britain able and willing to lend more than she has been lending in the past But, in the long run, the connection between purchasing power and actual purchases must be expected to reassert itself [1]

FAVOURABLE AND UNFAVOURABLE BALANCE OF TRADE. If, however, in the last resort, goods and services exchange for other goods and services, how can we explain that a completely equated balance of trade with all nations is the exception? In the first place, of course, we shall do well to remember that the "balance," whatever it may be, is a running balance. Although the Board of Trade figures are made up on 31st December, the traders of Great Britain do not strike a balance in their books on that date, and receive the surplus or pay the deficit, as the case may be. In order to understand what is happening, let us once again place ourselves in the position of a private individual, for the balance of trade and payments of a whole nation are nothing but the sum total of the various balances of trade and payments of its subjects.

The private individual usually lives by the sale of goods and services, and the receipt of other goods and services. Thus his receipts coincide with the sales, and his expenditure with his purchases However, there are numerous cases in which the private individual, by the sale of goods and services, receives either more or less than he spends on the purchase of other goods and services. This may be the case for short periods owing to the fact that he makes or receives gifts and penalties. Of greater importance than these individual cases of a transitory nature, is the case where expenditure and income differ one from another because one

[1] *Tariffs: The Case Examined*, edited by Sir William Beveridge

individual enters into credit relations with another. Here, four cases are possible—

1. Where a man does not spend all he receives but saves a portion of his income.

2. Where a man continues to save, but presently there comes a time when the interest accruing from his savings is greater than the amount of the new savings; he can now spend more than he receives from the sale of goods and services.

3. On the contrary, a person can spend more than he receives by borrowing money; that is, he utilizes the savings of those who receive more than they spend.

4. This borrowing is continued for some time until at last the time arrives when the sum total of interest and repayments becomes greater than the newly-borrowed money. When this point is reached, the private individual will be compelled to spend less than he receives.

Thus we have two pairs of cases of a favourable and an unfavourable balance of trade and services. What applies to the private individual also applies to the nation as a whole. Here, likewise, we may have occasional instances of a favourable or unfavourable trade balance which arises from the fact that a country gives or receives value without counter-services. It may be a matter of gifts or the transfer of property. There is also the singular case which could be observed in Germany during the period of inflation. So long as people considered that the mark would at some time or other regain its value, marks were retained by many for speculative purposes in the hope that their value would appreciate. Among these speculators for a rise in the value of marks were large numbers of foreigners who eagerly bought German paper marks in the hope of a rise. Whilst this demand lasted, Germany was able to import goods in return for the exported notes, but was relieved of the necessity of rendering any counter-service owing to the utter depreciation of the mark. The consequence was that Germany could import more than she had to export. If we now turn from this interesting but only temporarily important case of an adverse balance of trade, we find that the normal cause of a favourable or unfavourable balance of trade in the case of a nation lies in the nature of its credit entanglement with the rest of the world. Here,

as in the case of the private individual, there are four forms assumed by the balance of trade—

1. The case of a country which does not employ a portion of its proceeds from exportation, but allows it to remain as an investment of capital abroad and thus becomes a "creditor" nation. This is a "favourable" balance of trade.

2 The case of a nation which, by steadily increasing its capital investments abroad, finally reaches the point at which the sum total of the interest, dividends, and repayments exceeds the amount of the new loans. This is an "adverse" balance.

3. The case of a nation which gets into debt with foreign countries and which imports goods to the extent of this debt without rendering any present counter-service. This is the case of a country which is in the course of becoming a debtor country. Such a balance is said to be adverse.

4. The case of a nation which may possibly become increasingly indebted to foreign countries and ultimately reaches the point at which the sum total of the interest, dividends, and repayments due becomes greater than the newly contracted loans, so that the portion of the exports which corresponds to this newly-contracted debt can no longer be spent on imports, but implies the one-sided transfer of values to creditor countries. This is a "favourable" balance of trade.

We may reduce these various types of trade balance to a simple form in accordance with the foregoing explanation and say: the type of trade balance is the reflection of the type of capital balance. Hence it will be seen that the conclusions which we can draw from the position of a country's balance of trade are very different from those which are commonly read into it. We can no longer entertain the idea that a "favourable" balance, in the sense of a surplus of exports over imports, is in itself a satisfactory omen, and that an "adverse" balance is something to be deplored. An unfavourable balance of trade may be a sign that a country has attained to the position of a creditor, or it may be indicative of the fact that it is indebted to foreign countries. On the other hand, a favourable balance of trade may indicate a country which is in the course of becoming a creditor, as well as a pure debtor country. The form of the balance of trade is, in all cases, the consequence and never the

cause of the form of the capital balance. This relationship was brought out by Dr. Gregory when, in speaking of the position of our balance of trade in 1931, he said—

> If there is a world depression, and not the same necessity for export of capital as before, is it not reasonable that there should be an increased surplus of commodity imports? A larger proportion of national income than before is being drawn back; because so much is not being saved and reinvested abroad. Given a high standard of living such as that of this country, I am not at all surprised that we have a larger surplus in commodity account than we had [1]

There has arisen in recent months, a considerable controversy over the question of the balance of trade and of payments, and part of the justification for our system of tariffs has been placed on the supposed necessity for correcting an adverse balance of commodity account. Now, there is no doubt whatsoever that the balance of trade can be modified by political action, but the consequences of such interference are likely to be very different from those anticipated by many people. A large proportion of our imports are obtained in exchange for services, or form the tangible expression of the interest payments which are due to us from our overseas investments. Now, an examination of the figures on page 251 shows clearly that the greatest drop in the national income during 1931 was suffered through the decline in revenue from investments due to trade depression. If, therefore, we intend to impose added difficulties upon our debtors in their attempts to make these payments to us, the revenue from such sources is likely to shrink still further. This will certainly result in the diminution of imports which is so earnestly desired, but it will also entail a corresponding fall in our standard of living as well.

TEST PAPER 10

1. Is it true that England is being impoverished by her foreign trade, because the imports largely exceed the exports in value? Account for the excess in value of the imports.
2. What is the meaning of the statement that "imports pay for exports"? Reconcile this statement with the excess of imports over exports which the trade statistics of some countries reveal
3. Explain what is meant by the "export of capital" and show how it is related to the other items in a country's balance of payments
4. Discuss the changes in a country's balance of payments which may be expected to accompany the depreciation of its currency.
5. Draw the diagram on page 244 and explain its meaning

[1] Reported in the *Journal of the Royal Statistical Society*.

CHAPTER XI

TARIFF POLICY

We have shown in the course of the preceding chapters that the benefits which we expect to derive from the development of international trade are based upon the extension of the principle of the territorial division of labour, irrespective of national boundaries. Such a development postulates that the inhabitants of a given area are willing to concentrate their attention upon those economic activities which are most suited to the natural conditions of the country, and that all are willing to exchange the commodities which they produce for those which they need. Assuming that these conditions were fulfilled, it does not, of course, follow that every branch of economic production would become located in the most suitable area, but that each region would concentrate its activities on those branches of production in which it enjoyed the greatest *relative* advantage. But economic motives alone do not sway the minds of Governments and peoples, and the issue is complicated by innumerable considerations of a non-economic nature In the first place, the number of people who can "think internationally" is limited, and it is, after all, only natural that every person should possess a bias in favour of his own country. This bias too frequently, however, amounts to blind intolerance, and takes the form of a refusal to admit that any foreign country can excel the home country in any branch of activity. Hence we find all the forces of national prejudice arrayed against the full development of international freedom of exchange.

In many cases, however, the movement goes farther than this. One nation is always inclined to regard with suspicion the acts and motives of another, so that Governments are often afraid to allow the full development of territorial division of labour to take place because it will make them dependent on an outside producing area for certain essential supplies. This is particularly true in respect of the production of foodstuffs. A further difficulty arises in the course of determining the most suitable economic activities. Industries

are founded but, if these are of an unsuitable nature, then the force of outside competition should, in theory, cause a movement of capital and labour away from these occupations to a more profitable employment. In practice, however, neither labour nor capital display such mobility, and if an industry is depressed through foreign competition, labour remains stagnant in unemployment, waiting for "better times." Capital, which is invested in highly specialized plant and machinery cannot readily be realized without heavy loss to seek alternative employment. Moreover, the longer that an industry has been established, the greater is the reluctance on the part of those engaged in it to admit that its former advantages have passed away. In consequence, drastic industrial reorganization may be regarded as too heavy a price to pay for a cheaper supply of goods from external sources, and the Government may find itself called upon to take action to penalize the outside competitor

In the sphere of international trade, therefore, as in other branches of economic life, Governments have sought to control the free play of economic forces. They have done so upon a variety of pretexts and have employed for their purpose a formidable array of weapons. In the course of the following pages we shall examine the nature of these restrictions which have been imposed upon international trade by Governments, and attempt some analysis of the motives which have inspired them.

FOREIGN TRADE RESTRICTIONS. In pre-war days there were many signs to show that the spirit of government intervention in industry and trade was growing For a generation after the abolition of the Corn Laws in Great Britain freedom of trade made progress in Europe, not only through reductions of import duties, but also by relaxations of other forms of restriction. Thus there was an extension of the facilities allowed for the transit trade, and for the storage of imports destined for re-export. This result was accomplished partly by treaty agreements which widened the areas to which customs systems applied, and partly by independent national legislation In the 'sixties and 'seventies came a reaction. The United States led the way after the Civil War and became prosperous with extraordinary rapidity behind a high tariff wall. France and Germany speedily followed, for it was argued that although Free

Trade was of benefit to Britain it was not so certain that it was to the benefit of everyone else. "Economic Nationalism, routed by Adam Smith in his classical attack on the Mercantilists, began once more to raise its head. It was to be no part of German or American policy to maximize the world's wealth, if the benefits were to be concentrated in the hands of Great Britain."[1] In this country, the trade depression of the 'eighties gave rise to a "fair trade" agitation, leading to the tariff reform movement which, however, failed to secure general acceptance.

Since the War the spirit of interventionism has grown with alarming rapidity. A large number of restrictions were put into force during the War and, after the cessation of hostilities, they were either maintained in force or renewed Thus, in many countries there existed an elaborate system of import and export prohibitions which totally checked the trade in those commodities with which they dealt Such measures were adopted with an idea of reserving the raw materials produced in a country for national industries, so as to enable those industries to recover more quickly and to meet foreign competition. Another motive was that of stopping temporarily but completely, all imports, with a view to safeguarding industries that were created during the War. In certain cases, again, the prohibition of imports was adopted in a desperate attempt to save a rapidly-depreciating paper currency, as in the case of Austria and Germany. As was pointed out in the final report of the World Economic Conference, import and export prohibitions, and the arbitrary practices and disguised discriminations which result from them, have had deplorable results by hampering the normal play of competition, by imperilling both the essential supplies of some nations and the not less indispensable markets of others, and by bringing about an artificial organization of production and distribution. Prohibition of certain classes of imports may be instituted ostensibly for other motives than for checking foreign competition. Thus, the importation of some types of agricultural produce may be prohibited on account of disease Now, no one can deny that a state has both the right and the duty to protect its agriculture against animal and plant diseases, but the impression prevails in certain quarters that some states have taken too many

[1] G D. H Cole, *British Trade and Industry*

measures of this kind with the primary object of reducing foreign competition

A second, and less oppressive method of government restriction is the system of import or export licences, which are adopted for reasons very similar to those mentioned in connection with prohibitions. Thus, in the period of the depreciation of the German mark, purchases from foreign countries were brought within a system of licences issued in advance by an official body set up for the purpose. In 1931 and 1932, the majority of European countries adopted similar measures for limiting the volume of certain classes of imports by quota systems In France, for example, this system was applied to a wide range of imports including timber, coal, and a wide range of foodstuffs. Czechoslovakia adopted an arrangement for the importation of corn and flour under which these commodities could be obtained only on condition that the importer purchased a corresponding quantity of home produce. In Turkey, quotas were adopted in conjunction with a "compensation" system whereby each country trading with Turkey was expected to buy Turkish goods to a value approximately equal to its imports into Turkey. Again, in the case of Austria, the importation of coal was reduced by the introduction of compulsory measures to ensure the use of Austrian coal. A committee was elected to decide in which cases Austrian coal was to be used partially or exclusively. In particular, coal merchants were obliged to sell a certain percentage of Austrian coal along with the foreign coal. These, and many other measures of a similar nature were adopted all over Europe so that by the early months of 1932 international trade was practically "frozen up."

In Great Britain a very similar system has received the sanction of Parliament with regard to wheat. The object of the Wheat Quota Act is to provide wheat growers in the United Kingdom with a secure market and an enhanced price for home-grown wheat of millable quality, without a subsidy from the Exchequer, and without encouraging the extension of wheat cultivation to land unsuitable for the crop. The millers are required to absorb from the wheat growers in each cereal year a quantity of home-grown millable wheat which may reach but must not exceed 6,000,000 quarters of 504 lb. The Minister of Agriculture will prescribe each year the quantity of such wheat which he anticipates should be sold by

growers Millers will continue to buy, as before, in a free market, but in order that the growers may receive an enhanced price, "deficiency payments" are provided for. That is to say, the growers receive, in addition to the price which their wheat has fetched in the open market, the difference between the average market price of all home-grown millable wheat sold during the year and a standard price of 45s a quarter. For example, consider the case of two farmers, one of whom has sold his wheat for 30s a quarter and the other for 26s. a quarter. The average price of all home-grown wheat sold was, say, 28s. a quarter, that is to say, 17s less than the standard price of 45s. The first farmer will ultimately receive a total of 47s., and the second a total of only 43s., the intention being to encourage the growing of good and to discourage the growing of poor wheat.

The money for this subsidy to the farmers is found by the flour millers and flour importers who are compelled to pay a Wheat Commission a certain sum for every sack of wheat delivered to customers. The amount per sack depends on the price of wheat and the number of sacks of flour delivered. Probably the best that can be said of this measure and its cumbersome administrative machinery is that it may not raise the price of bread to the same extent as would an ordinary tariff.

A tariff (in effect) takes money out of the pockets of the consumer and hands over some of the proceeds to the home producer. The rest goes into the Exchequer as revenue. But the Exchequer gets no revenue out of the quota. Everything that is taken from the consumer goes to the farmer. Thus the quota makes it possible to confer a given amount of benefit on the farmer at a smaller sacrifice from the consumer than would be entailed by a tariff.[1]

Yet, it is argued by the milling interests that the quota system is so cumbersome that it would be better to put a straightforward duty on wheat. The delicate machinery of the wheat trade would not then have been interfered with, and the millers would have had accurate information regarding costs. At present, the quota payment in respect of flour deliveries must be uncertain and subject to changes.

CUSTOMS TARIFFS. Of all the weapons employed by Governments to regulate the flow of international trade, the tariff is the most

[1] *Tariffs: The Case Examined*, edited by Sir William Beveridge.

common as well as the most important. In speaking of a tariff we refer to a system for the imposition of taxes on commodities as they pass over national boundaries. The precise nature of the tax varies; sometimes it is levied in proportion to quantity or weight, sometimes it is based on value; occasionally the duties may be of the "inverted" type, rising when prices fall and *vice versa.* Over and above such complications as these, it is usually considered necessary to grant some exemption to goods which are destined for re-export. This may take the form of an exemption from the payment of duty, as under Section 13 of the Import Duties Act, 1932—

> Where it is shown to the satisfaction of the Commissioners that any goods are being imported solely with a view to the re-exportation thereof—
>
> (*a*) after undergoing a process in the United Kingdom which will not change the form or character of the goods, or
>
> (*b*) after transit through the United Kingdom, or by way of transhipment,
>
> the Commissioners may, subject to such conditions as they think fit to impose for securing the re-exportation of the goods, allow the goods to be imported free of any duty chargeable under this Act.

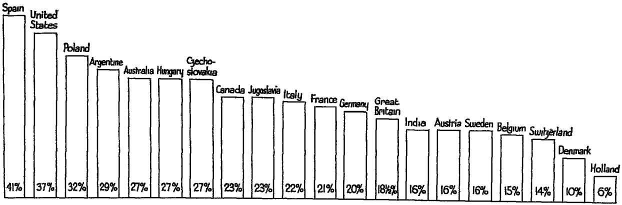
In cases where goods have to be worked up or subjected to some manufacturing process before re-exportation, then the duty paid on admission may be partly or wholly refunded when the goods are shipped, in order to encourage the export trade. This remission of duty is known as a *drawback*, and often assumes very complicated forms with the object of granting protection to the home manufacturer and yet allowing raw material to be purchased at competitive prices for the export trade. As an example of the necessity for such arrangements under a system of protection we may consider the case of the British metal-finishing trades, which from the standpoint of the employment which they give, are of greater importance than crude iron and steel production. Sheet bars, produced abroad, are imported into this country and re-rolled into sheets, galvanized, and exported in the form of galvanized corrugated sheets to all the markets of the world. With the imposition of a duty without a drawback upon foreign sheet bars which are rolled and worked up in Great Britain, then, sooner or later, the rise in price must cause a diversion of the work to foreign countries

where the raw material can be obtained more cheaply. An increase in the price of raw material may mean all the difference between obtaining an order for British rolled material or losing the business. Similar arguments may be put forward regarding the finishing trades in the wire industry. In many cases imported billets are rolled down into rods, drawn into wire, this wire being then manufactured into wire netting, woven wire, and similar articles. Here, again, the question of price in overseas markets is one of great importance, and a high price for the new material may involve the loss of orders for works situated in Great Britain, particularly in the case of those works which, situated near a port, are not near large steel-making centres. In such circumstances a system of drawbacks, however clumsy and difficult to administer it may be, is indispensable if the export trade is not to suffer.

In considering the tariff policies of different countries we find a very wide range of diversity. Some countries follow a policy of high tariff protection, excluding by heavy duties all those goods which they can possibly produce at home. Directly opposed to such a policy is that of free trade which, although it has never resulted in an absolute abolition of all restrictions, allows the unrestricted import of practically all goods which can be bought more cheaply in foreign markets Between these two extremes we find tariffs of varying magnitude according to the convictions of Governments and the pressure which interested parties can bring to bear upon them.

Amongst the varied disturbances from which international trade has suffered during the past ten years, probably the most serious have been caused by the incidence of tariff barriers, which have delayed recovery from the effects of the War and have seriously hampered the foreign commerce of all nations. So far as Europe is concerned, the problem has been further complicated by political readjustments which have changed frontiers and increased the number of independent customs units, all of which strive for an independent national economy which they defend by means of tariff barriers. The World Economic Conference held at Geneva in 1927 condemned them in unambiguous terms, recommending that "the nations should take steps forthwith to remove or diminish these tariff barriers that gravely hamper trade, starting with those which have been imposed to counteract the effects of disturbances arising out of the

RELATIVE LEVELS OF TARIFFS ON MANUFACTURED GOODS



The above diagram gives a rough indication of the relative levels of the tariffs in a number of different countries, in June, 1932 It will be seen that the existing tariffs in force in Great Britain at that date have placed us in a group of countries following a "moderate" tariff policy.

War." The first test of the willingness of the Governments to comply with this recommendation came when delegates assembled in November, 1927, to discuss the Draft Convention "for the abolition of import and export prohibitions and restrictions." This convention allowed a large number of such restrictions to continue, some of which allowed considerable latitude to the signatories. Thus any State was allowed "to take on importation or exportation all necessary measures to meet extraordinary and abnormal circumstances, and to protect the vital economic and financial interests of the State." After three weeks' debate, eighteen states signed the convention out of the thirty-four which were represented—a circumstance which could not be construed into a very enthusiastic acceptance of the principles enunciated by the Conference.

Yet, if in 1927 the growth of protection seemed formidable, the rivalry in the creation of customs tariffs has since increased. Even prior to the restrictionist mania of 1931 and 1932, many countries had made big increases in their tariff structure. A notable example was the adoption of the Hawley-Smoot tariff in the United States in June, 1930, which has had repercussions all over the world. The complaints of European producers have led to retaliatory measures being taken, such as revisions of the import duties on motor-cars. In view of the trend of events since the Conference, a cynic might well have said that all that most of the delegates and experts meant was that they would each be very glad to see the tariffs of all other countries abolished, but had no intention of touching their own.

COMPLEXITIES OF TARIFFS. The World Economic Conference went much farther in its examination of the tariff situation than merely condemning the excessive increase in import duties It considered in addition, the technical aspects of tariff making, and drew attention to a number of serious defects such as the absence of a common nomenclature, the complexity and instability of tariffs, the vexatious measures and formalities encountered in the application of tariffs, and finally export duties. Further, the conference urged the necessity for the completion of long-period commercial treaties between countries, guaranteeing fair and equal treatment as regards customs duties and the conditions of trading.

In the first place, dealing with the complexities of modern tariff systems, there can be no doubt that the enormous increase in the

number of tariff headings, which is a characteristic of post-war tariff building, has constituted a very considerable obstacle to the development of international trade. In other words, business has been hampered by the fact that the tariffs of the world have concealed discriminations under the guise of unintelligibility and complexity. Such obscurity is largely due to the varied terms in which articles subject to duty appear in different tariffs. If traders are liable to make mistakes as to the amount of duty payable on certain classes of goods that are not clearly defined in the tariff, the volume of trading is certain to suffer. It is of the greatest importance that the nomenclature adopted by the customs authorities of all countries should correspond as closely as possible with the actual types of goods manufactured and their current trade names, supplemented, if necessary, by their scientific designation. Furthermore, every customs classification should be as objective as possible, lest it should become a means of discriminating to the prejudice of any country.

One of the greatest obstacles in the way of establishing permanent and secure trade relations between countries is the instability of tariffs. It is essential that industrialists, when organizing their production with a view to placing goods on a foreign market, should not be subject to the risk of finding duties suddenly raised to such an extent as to prevent the entry of their goods. It is only natural that traders should hesitate to incur the costly expenditure entailed by business organization for foreign trade, if they are not certain of access to foreign markets for the length of time required for the recovery of their capital outlay. Such expenditure may include the purchase of industrial plant and special equipment, as well as the expenses involved in the establishment of an elaborate sales organization overseas, the costs of advertising campaigns and other propaganda. Further, all these developments must be preceded by the preparation of schemes representing a considerable expenditure of time and money. In the absence of tariff stability, few people will be found ready to face these risks A clear example of the results of such instability is to be seen in the case of the United States. In that country, the flexible provisions of the Tariff Act empower the President, on a report of the Tariff Commission, to increase or decrease rates of dutv and to change the

classification of articles so as to equalize the cost of production in the United States and the principal competing countries. In consequence, many British firms have given up any attempt to deal in that market. They argue that even if they are able to cut down their costs of production to a point where their goods can just bear the tariff, they must face the possibility of a further duty designed to take away from them the very advantages which their enterprise and skill have given them over the domestic manufacturer.

Another source of tariff instability arises where taxes have been imposed as a protection against "exchange dumping" from countries with a depreciating currency. It has been shown, however, that even the most rapid manipulation of tariffs is not an effective method for dealing with the still more rapid changes which are caused by monetary instability. Exchange fluctuations are, in themselves, sufficiently injurious to international trade, and rapid tariff changes serve only to make matters much worse. Thus, in 1931, when a large number of currencies left the gold standard, the French Government imposed a 15 per cent surtax on goods imported from countries with depreciated currencies. This measure operated most harshly against Great Britain and caused a considerable amount of friction between the two countries.

In pre-war days, in order to overcome the disadvantages of tariff instability, it was the aim of Governments to enter into long-dated commercial treaties, limiting the scale of duties for certain articles. Stability of tariff arrangements was, in fact, preferred in many cases to a reduction of duties. In many cases, the element of stability was secured by a tariff guarantee known as the "consolidation" of duties, which involved an undertaking that the existing rates of duty would remain unaltered so long as the treaty remained in force Since the War, however, the uncertainty which overshadows the whole economic future of many countries has caused the negotiators of commercial treaties to hesitate to bind themselves for any long period. Yet, it has been stated that—

> The real value of Conventions as a safeguard to international commerce depends not so much on the length of the initial period within which they cannot be abrogated as on the explicit and uniform character of the terms in which they lay down the mutual obligations of the parties. In this respect, "multilateral" Conventions have the great advantage over the more usual "bilateral" Commercial Treaties that

the stipulations applicable to all the parties are expressed in identical terms, and tend therefore to establish a common economic doctrine or standard, the influence of which may extend far beyond the circle of states by which the Convention is ratified. On the other hand, the bilateral treaty has the advantage that its provisions can be closely adapted to the needs of the two contracting states without the necessity of being "watered down" in order to take account of the varying conditions and points of view of a large number of other countries [1]

Yet another factor making for instability in tariff arrangements is the omission of the most-favoured-nation clause from post-war commercial treaties, or imposing so many exceptions that the clause becomes meaningless This clause furnished the parties to any treaty containing it with a valuable guarantee that they would be placed on an equal footing with foreign competitors as regards the level of duties levied by the contracting parties at their frontiers. The insertion of this clause prevented a treaty from being concluded for a term of years and then more favourable treatment being subsequently granted to a third party. It has become recognized in recent years, however, that the most-favoured-nation clause has become unjust in its application, and has tended to prevent the lowering of trade barriers. If a country *B* concludes a tariff agreement with *A* whereby the latter is induced to lower tariff barriers, then country *C* reaps precisely the same benefit without making any sacrifice, if she has previously entered into a most-favoured-nation treaty with *A* To many of the customers of country *A* who impose low duties or no duties at all upon her trade, it is a serious discouragement when their goods are treated no better than similar goods from countries employing high tariffs It is therefore being urged that the time is now appropriate for a re-interpretation of the most-favoured-nations clause in order to prevent this anomaly, and allow bilateral treaties to be made without the general extension of all their provisions.

TARIFFS AND SELF-SUFFICIENCY. One of the principal reasons for the growth of tariffs, particularly since the War, both in Europe and elsewhere is the development of the spirit of economic nationalism whereby the various National Governments pay homage to the alluring ideal of self-sufficiency. By the aid of a tariff it is

[1] *Final Report of the Committee on Industry and Trade.*

hoped to strengthen home industries in the face of foreign competition, and to attain a degree of economic independence.

> The aim of every country has been, and still is, to make itself, so far as possible, a self-sustaining economic unit There is everywhere a desire to ensure that, without a fundamental dependence on outsiders, the members of individual nations shall be able to live. And so it is that there is a constant striving to balance agriculture with handicrafts, to effect a mutual exchange within the nation [1]

This idea of self-sufficiency can be seen at work amongst the new political groups formed under the treaties of peace, the aim of each being to form an economic unit as powerful and as diversified as possible and, above all, capable of meeting the principal needs of the population These new states, proud of their newly acquired political independence, have attempted by means of protection to gain economic independence. The case of the Danubian countries is typical. The former Austro-Hungarian monarchy, although poor and with a small volume of foreign trade, had achieved a certain balance between its industrial and agricultural activities. Under the Peace Treaty it was divided without any regard to economic considerations, thereby destroying such balance as formerly existed. Moreover, in the years which have followed, a policy of ill-considered nationalism has led to a duplication of both industrial and agricultural activities, so that the economic structure of territories which formerly formed parts of one territorial unit, have gradually drifted apart. In addition, on account of the protectionist policy which has been pursued, the trade between these areas has been reduced to less than half its pre-war level. The pursuit of such policies results almost invariably in a waste of capital and of effort since it brings about a redundancy of industrial plant. As the American economist Hadley very rightly remarked many years ago, the protection system has doubled the means of production and curtailed opportunities of trade. This injurious maladjustment usually becomes apparent only too late.

A system of protection is sometimes advocated on the ground that tariffs, judiciously selected, increase the diversity of economic activities within a country. It has been argued that such a diversity is highly desirable because those countries in which a balance

[1] A Ramsay, *The Economics of Safeguarding.*

exists between different industries, such as agriculture and manufacture, are able to resist better the effects of a general economic depression. Such a general thesis is difficult to maintain. If we can postulate the existence of a completely self-sufficing economic unit, entirely independent of outside areas, then we might be justified in assuming that external trade fluctuations would have no effect upon its internal economy. Thus, there would be no complications arising out of international competition, and since such a country would be independent of foreign trade, its industries would not be dependent upon the vagaries of overseas markets or be affected by the rise of new competitors Yet such an area would not be immune against internal disorders which would cause disasters as great as those originating from outside sources. Mere diversification of industry could not, of itself, solve the problem, and when, in addition, we are confronted with the fact that no area is truly self-sufficient, then the above position becomes untenable. Even in the case of the United States—the country which most nearly approaches the self-sufficing political unit—we find that wide diversification of industrial activity and high tariff barriers failed to give security in 1929–32.

TARIFFS AND NATIONAL SECURITY. Although, generally speaking, tariffs cannot advantageously be used to compel the industry of a country to flow into channels for which it possesses no natural advantages, merely for the purpose of securing diversification of industries, yet a case may be established for the use of this method in the case of special industries or processes which, for reasons of national safety, it is considered essential to carry on within the country When the principle of territorial division of labour is allowed to work out its full consequences, unfettered by State control, certain industries may tend to become concentrated in a limited number of areas So long as these commodities can be obtained freely by international exchange no difficulty arises, but in the event of an outbreak of war, the dependent countries may find themselves in a precarious position on account of the cessation of supplies. Apart from the possibility of war, there is always a danger that the foreign Government will attempt to exploit its position by imposing onerous terms upon consumers. Hence there arises a general desire to foster the growth of such industries by artificial

means if they show no signs of healthy development without assistance. The difficulty immediately arises, of course, when the Government is called upon to decide what industries are essential for national security. Once the general principle has been admitted, it may lend itself to a very liberal interpretation.

As an example of the employment of tariffs in the interests of national security, let us consider the "key industries" legislation passed in Great Britain. On the outbreak of war in 1914, there arose an urgent need for a rapid expansion of the output of all materials required for the prosecution of hostilities. Articles such as dyestuffs, drugs and other chemicals, manures, scientific glassware and instruments, to mention merely a few, were found to be essential in large quantities for war purposes. The sudden cessation of imports from enemy countries caused considerable embarrassment to the authorities in this country, and a serious delay was experienced, at a time of urgent need, before the deficiency could be made good from domestic sources of supply. In consequence, it was brought home to those responsible for the organization of supplies in Great Britain the extent to which we were dependent upon imports of certain indispensable commodities. Later on, the term "key industry" was extended to cover not only those products which were essential for purposes of national defence, but also those which were necessary in large and important British industries, forming an essential part of our commercial life.

As an example, let us consider the case of the chemical industry. For a long period of years prior to 1914, the British chemical industry had primarily devoted itself to the manufacture of heavy chemicals, and in this branch of manufacture the United Kingdom was probably in advance of most other countries. With regard to fine chemicals, however, a very limited number were manufactured in this country and mostly in small quantities, whilst those which were made were not held in such high repute as those of foreign makers. Dyestuffs form one of the most important classes of these fine chemicals, and in this branch of production this country was very far behind the foremost continental manufacturers. Our total consumption of dyes in 1913 was estimated at some 45,000,000 lb., and of this Germany supplied about 38,000,000 lb., the remainder being made up partly by Swiss imports and partly by home

production. It would be safe to say that before the War we were dependent on imports to the extent of over 80 per cent of our dyestuffs needs, and, with the restriction of foreign supplies, our own insufficiency was brought home very clearly. It was, therefore, argued that the establishment of a large dye-making industry in this country was desirable in order to safeguard the textile industries against the ill consequences of dependence on foreign sources. It was further urged that our backwardness in the industrial application of organic chemistry had caused a shortage of trained industrial chemists whose services could be utilized in the production of all the chemical requirements of war.

During the War considerable developments took place in the dye industry, and after the War, in order to protect it from the competition of the German manufacturers, the Dyestuffs (Import Regulation) Act,1920 was put into operation. This Act prohibited for a period of ten years the imports of all types of dyestuffs and intermediates except under licence from the Board of Trade. Under the stimulus of this vigorous protection the dyestuffs industry expanded rapidly. Yet, upon the expiration of the Act it revealed the usual defect of tariff legislation in that the dyestuffs manufactures were successful in securing its renewal in the face of strong opposition from consumers. In addition to the dyestuffs industry, protection was afforded to a number of other "key industries" under the Safeguarding of Industries Act, 1921.

INFANT INDUSTRIES. Closely allied with the foregoing is the argument which asserts that new industries stand in need of a tariff to protect them from foreign competition. This excuse has been advanced probably more than any other to justify the beginnings of a system of protection. It received the qualified approval of John Stuart Mill who dealt with it as follows—

> The only case in which, on mere principles of political economy, protecting duties can be defensible is when they are imposed temporarily (especially in a young and rising generation) in hopes of naturalizing a foreign industry, in itself perfectly suitable to the circumstances of the country. The superiority of one country over another in a branch of production often arises only from having begun it sooner. There may be no inherent advantage on one part, or disadvantage on the other, but only a present superiority of acquired skill and experience. A country which has this skill and experience yet to acquire, may in other respects be better adapted to the production than those which

were earlier in the field, and besides, it is a just remark of Mr. Rae that nothing has a greater tendency to promote improvements in any branch of production than its trial under a new set of conditions But it cannot be expected that individuals should, at their own risk, or rather to their certain loss, introduce a new manufacture, and bear the burden of carrying it on until the producers have been educated up to the level of those with whom the processes are traditional A protecting duty, continued for a reasonable time, might sometimes be the least inconvenient mode in which the nation can tax itself for the support of such an experiment. But it is essential that the protection should be confined to cases in which there is good ground of assurance that the industry which it fosters will after a time be able to dispense with it; nor should the domestic producers ever be allowed to expect that it will be continued to them beyond the time necessary for a fair trial of what they are capable of accomplishing [1]

The infant industry tariff has, therefore, some theoretical justification where a new industry requires temporary support until it gets over the difficulties of the initial stages of its establishment. Unfortunately, those who have employed this principle to justify the imposition of tariff barriers have totally overlooked the qualifications with which it is hedged about, and which destroy its usefulness as a practical argument.

The infant industries argument was originally introduced by Alexander Hamilton, the first secretary of the United States Treasury, at the time of Washington. It is natural that the idea should have arisen in a progressive colony which was trying to assert itself against the superior industrial power of the Mother country. Of course, there has always been a tendency to abuse the argument by employing it as an excuse for the indiscriminate introduction of protective duties. It is too easily forgotten that, according to the infant industry argument, protective duties are permissible only under certain definite assumptions—that they become unnecessary within a measurable period of time through the development of the industry, and that they should not be higher than is necessary for the attainment of that purpose. An infant industry duty is justified only if the present sacrifices can be made good by the future gains, and, furthermore, only then, when it really needs this support from the State in order to safeguard the development and to strengthen the industry in question. The circumstances where a tariff may be

[1] *Principles of Political Economy.*

legitimately imposed may be summed up in the words of Mr. G D. H Cole—

> A tariff is only justifiable, broadly speaking, where there is a good prospect that its imposition will increase the total of national wealth, and not simply divert production and employment from one industry to another. This means that the productivity of capital and labour in the protected industry must be—at least potentially—greater than their productivity in any alternative uses that are open to them within the country concerned, even if they are less than the productivity of capital and labour in the protected industry in other countries It means, secondly, that the indirect effects of the protection on other industries, or on the general body of consumers, must not be so adverse as to offset the gain in productivity from the transference of capital and labour to the protected industry. And it means, thirdly, that these advantages must be realizable within a reasonable period, and must be of sufficient magnitude and certainty to offset the *prima facie* arguments against imposing barriers in the way of trade.[1]

It is questionable whether a tariff has ever been introduced which has done justice to these postulates. Customs duties which have been introduced as infant industry duties have rarely ever been abolished. Thus, the first customs tariff of the United States of 1789 was to remain in force for seven years only, but as a matter of fact, American customs duties have continually risen since that time, and the same remark applies to other protectionist countries. Even in the mind of List there seems to have been an idea that infant industry duties, after having fulfilled their purpose, would immediately be abolished, since the strengthened industry, through the competition of manufacturers one with another, would render the duty ineffective so that the manufacturers would have no further interest in retaining it. Post-war experience in this country alone shows how futile is such a hope. After ten years of protection the dyestuffs industry was not prepared to dispense with its tariff, and the same is true of all our new "safeguarded" industries. The "infant" can never be induced to admit that it has grown up.

TARIFFS AND AGRICULTURE. As we have already seen, one of the most striking consequences of the War was an accentuation of the tendency of many States towards a policy of national self-sufficiency. The attitude in respect to agriculture possibly illustrates this tendency more clearly than any other case. During the War, large areas

[1] *British Trade and Industry.*

on the Continent formerly devoted to food production were compelled to suspend operations, whilst labour troubles and the derangement of the distributive system caused both local and general disturbances in the food situation. The production of agricultural products outside Europe was stimulated in order to make good the shortage. Immediately after the War, as there was still a shortage of supplies, a number of States entirely or partially suspended their protective duties on agricultural products. As soon as the European Governments commenced the work of national reconstruction, however, they entered upon an era of intensified agricultural protection. In particular, the duties on cereals have been raised to counter the over-production of grain which has occurred as a result of the mechanization of agriculture and the extension of the acreage under crops.

Protection in agriculture has all the undesirable consequences which follow its application to manufacturing industry. Customs barriers, in order to be effective, must raise prices to a level higher than would have been the case in the absence of protection, whilst they also tend to encourage production in countries where the natural conditions are unsuitable for cheap production. Yet agriculture furnishes a clear case where the purely economic motive is not the only one governing the imposition of a tariff. We have to take into account social and political exigencies which make the preservation of agriculture a vital question in the eyes of the majority of Governments. They believe that any reduction of agricultural protection would reduce a large peasant population to distress. It is their object to maintain a strong peasant population, not only to safeguard the provisioning of the country in times of emergency, but because a prosperous peasant class represents an element of order and tranquillity. There appears to be an inherent tendency in the world of industry for production to proceed in a cyclical manner, and it is considered in many quarters that where a nation contains within its own borders a flourishing agricultural community, this fact may exercise a stabilizing influence.

Such considerations as these help us to understand something of the paradox of agricultural protection. We have spent much ingenuity in developing and perfecting systems of world transport, and have devoted much time and energy to securing the cheap and

swift transport of commodities. Such devices as refrigeration and cold storage have been perfected to allow perishable agricultural produce to be carried great distances in good condition so that we may draw upon the resources of specialized producing areas. When we have succeeded in achieving these very desirable results, then Governments proceed to exercise their minds in discovering methods whereby these advantages possessed by overseas areas can be offset.

> In the Argentine they can produce beef at £1 per cwt; here it costs 50s per cwt. The Argentine has no winter to contend with, that wonderful forage crop, lucerne, which is unsurpassed for the production of live stock, grows like a weed there. Nature has blessed the Argentine with a wonderful climate, and nothing known to science can enable Britain to overcome that [1]

Logically, we might ask, why try to overcome such an obvious natural advantage? In practice we find that Governments have been unable or unwilling to face the serious social problems which a decline in national agriculture would have caused, and have attempted to stave off any serious consideration of them by resorting to protection to preserve the existing position.

TARIFFS AND RATIONALIZATION. The great rapidity of technical progress, which has been a characteristic feature of so many industries since the War, has created serious problems for many British industries. The modern industrial unit requires a heavy expenditure in plant and equipment which, in an era of rapid technical invention may quickly become obsolete It is therefore only those undertakings which possess large financial resources that are in a position to modernize their plant, whilst it is only those firms which do so that can maintain their competitive position. Yet, as the Committee on Industry and Trade pointed out, "Financial weakness always tends to constitute a vicious circle, for an undertaking or industry whose earnings are insufficient to provide for depreciation and reserves finds great difficulty in keeping its equipment up to date; and the more antiquated and inefficient becomes its equipment, the greater becomes the financial weakness and the smaller becomes the possibility of obtaining the fresh supplies of capital which may be the only means of restoring profit-earning power."

[1] A. P. McDougall in *The Listener*.

Many of the basic industries of this country have had a most unfortunate post-war history, and their low profit-earning capacity together with their heavy burden of fixed-interest charges has made it impossible for them to obtain the capital necessary for modernization. It has therefore been argued that if such manufacturers were given the benefit of a tariff which would protect them from foreign competition and give them an assured market in this country, they could then proceed to re-organize, and could offer prospects sufficiently attractive to the investor to secure all the new capital which they need. This argument has been applied particularly to the case of the British iron and steel industry in which, as has been pointed out time after time, the general level of technical organization is inferior to that prevailing elsewhere. With the industry in a state of depression it is out of the question to obtain the required capital, but with a protected home market it would be possible to expand operations and create confidence in the minds of the investing public Furthermore, it is argued, under conditions of continuous working and expanding output, the economies of large-scale manufacture can be realized, and on account of the fact that heavy overhead charges can be spread over a greater volume of output, the consumer will not suffer from an increase of prices. In order that these benefits may be realized, some supporters of this view have introduced two qualifying conditions, namely, that the commodity must be one the production of which can be increased indefinitely, and for which this country possesses at least average advantages and possibilities of efficiency. These qualifications, however, like those associated with the infant industries argument, are capable of a wide interpretation.

It has been very legitimately argued that if an expansion of output is all that is necessary in order to lower productive costs to a level at which manufacturers can meet outside competition, then all that they need to do is to expand production without waiting for protection and thus secure their results. In reply to this, it is usually argued that wages and labour conditions are inferior in competing countries to those prevailing here, or that foreign manufacturers are "dumping" their products here below cost price A tariff is therefore needed to offset these disabilities so that, behind its shelter, the industry can obtain a reasonable price in the home market and can,

in its turn, dump any surplus abroad where a market can be found. In this way, it is argued, the export trade will expand. In the first place it is fairly evident that the domestic consumer will be expected to pay a higher price than the foreigner and, inasmuch as the manufacturer will desire to work at a profit, we may assume that the lower the export price the higher will be the price in the home market in order to make up the difference. Moreover, the foreign manufacturer, excluded from our market by a tariff, will seek to place his goods elsewhere, so that the increased competition is likely to drive down external prices still further, thereby increasing the burden on the home consumer.

Again, once the tariff is imposed, the programme of rationalization becomes less urgent. Many of the more reasonable advocates of protection state that tariffs should be made conditional upon a given industry being able, within a reasonable time, to demonstrate its efficiency by producing goods at prices in close relation to world parity. Such a condition is easy to impose on paper, but cannot always readily be realized in practice, and despite all protestations to the contrary, the danger of a tariff acting as a shelter for inefficiency is very real.

A further difficulty arises, too, from the standpoint of the producer in the confusion of thought existing between the *scale* of production and the *volume* of production. We may obtain the volume of production necessary to supply a protected home market from a small number of concerns working on mass production lines or from a large number of undertakings each with a relatively large output. The advocates of protection for the purpose of securing rationalization usually assume that the first type of organization is the one which will apply, but such an assumption is quite unjustified. Take the case of the iron and steel industry to which this form of argument has been so frequently applied. Here, production is carried on by a relatively large number of firms of a wide diversity of sizes with varying degrees of efficiency. The imposition of a tariff, by curtailing foreign competition, will enable home producers to obtain a higher price for their product, and the number of firms which will be able to cover their costs of production in the new circumstances will depend upon the degree of protection and their efficiency of working. Provided that the tariff is sufficiently high, quite a large

number of relatively inefficient producers may be able to continue in business at a profit without taking any steps to modernize their plant. Indeed, in many cases, this will be out of the question, because the most serious defect is due to faulty location which can be remedied only by moving the plant elsewhere In this case concentration of production will not take place very quickly. The more efficient producers may, however, take steps to rationalize in one of two ways. They may expand production and lower prices in order to secure the home market and eliminate the less efficient producer by a price war. In the course of the struggle the consumer gains by the low prices, but the tariff will be of little benefit to producers, since if the competition is sufficiently keen a large number may still be working below cost of production. This position is hardly likely to continue for long. The most inefficient producers may be driven out of business, or, as is far more probable, will either be absorbed by their more successful competitors or enter into a working agreement with them. In either case, the consumer is likely to find himself confronted by a monopolistic or semi-monopolistic organization of producers who will keep prices at as high a level as possible without provoking foreign competition.

TARIFFS AND CONDITIONS OF LABOUR. Amongst the varying and frequently conflicting arguments put forward by the supporters of a policy of protection is that of employing tariffs for the purpose of neutralizing "unfair" conditions of competition. It has been said that the foreigner can produce at a lower rate of cost than his British competitor because he pays lower wages to his workpeople, trade union restrictions are not enforced, and the burden of taxation is not so high. This point of view is probably one of the most superficially attractive arguments which is invoked in support of a tariff. Unfortunately, however, the argument is open to the serious objection that the workers whose standard of living is most seriously threatened are those engaged in the exporting industries which are suffering from loss of overseas markets—

> The workmen whose standard of living is most in peril in Britain to-day, having gained least or not at all since the War, are to be found for the most part either in trades dependent on export or in agriculture. The coal miner, the cotton operative, the boilermaker, and the fitter will find small help to their standard of life through the taxation of imports; they are being threatened not by imports into Britain, but

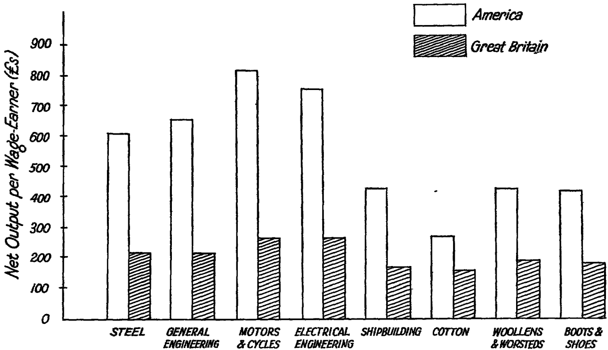
by competing exports into neutral markets. The British farm labourer, on the other hand, is suffering mainly from imports, but the imports are mainly the product not of worse-paid but of better-paid workers in other lands.[1]

In the first place, a high standard of life by no means leads to a high cost of production, indeed, usually the result is precisely the opposite. The level of labour cost per unit of production does not vary proportionately to the remuneration of labour per unit of time, since it is affected by a large number of other factors such as the personal efficiency of the workers, and the degree to which they are assisted by machinery and other forms of fixed capital. It is the productivity of labour in different countries which is the decisive factor, and how strikingly this may vary between one country and another is illustrated by the chart on page 288. The data upon which the chart is based reveal the fact that the value of the net output per worker in the United States over that in Great Britain was 177 per cent in the steel industry, 194 per cent in general engineering, and 200 per cent in the motor and cycle industries. It is true that the comparison is not subject to a high degree of accuracy; the grouping of the industries in the two countries corresponds only approximately, and the price level prevailing in the two countries was not the same, being as a general rule higher in the United States, but, nevertheless, the difference is striking. With regard to wages, the average earnings of textile workers were about £1 14s. per week, whilst those of the workers in the northern textile area of America were over £4 per week, and in the southern area were over £3 per week, or 133 per cent and 84 per cent respectively higher than the British rates In other branches of activity a very similar discrepancy was to be found, so that a high standard of wages is very far from implying a high level of wages cost

Further, the different levels of wage rates which are so frequently alleged to handicap the British industrialist cannot readily be compared, and investigation of them sometimes brings to light unexpected results. In connection with the production of iron and steel, for example, it has frequently been stated that the competition offered by the Belgian industry is due to the fact that the Belgian worker is sweated and is on an unduly low standard of living. In

[1] Sir William Beveridge, *op cit*

DIAGRAM SHOWING THE RELATIVE PRODUCTION PER HEAD OF BRITISH AND AMERICAN WORKERS IN CERTAIN INDUSTRIES



The above diagram gives an approximate comparison of the relative productivity of British and American workers as measured by the value of output per wage-earner. The figures are based upon the British Census of Production of 1924 and the American Census of Manufactures of 1925. Allowance must be made for differences in the price levels of the two countries, but even when this is taken into consideration it will be seen that the productivity of labour is much greater in the U S.A. than in Great Britain

1930 an impartial investigation[1] showed that the *nominal* wages of the Belgian worker were equal to 69 per cent of average British wages. The inquirers then investigated the purchasing power represented by these nominal wages as well as the general conditions of life of the working classes in both countries. With regard to housing conditions, it appeared clearly that the Belgian workman was definitely better off than the British, since rents were about half as high. Moreover, a considerable percentage of the houses were owned by the workmen, whilst in other cases they were often provided by the factories on exceptionally favourable terms. With regard to food, taste and custom vary so much from one country to another that direct comparison was difficult, but whether the food budget of the English cost of living index number was taken or that of the Belgian index, the result was the same—prices were in favour of the Belgian worker by at least 23 per cent. For clothes, transport, taxes, entertainments, and other items of expenditure, price comparisons showed a still bigger discrepancy in favour of the Belgian worker. These results furnished strong evidence for believing that the success of the Belgian iron and steel works does not depend on a lower standard of living for their labour.

The differences in cost which arise are due, then, not so much to differences in wages as to differences in the productivity of labour. In any country, however, this productivity will vary from one occupation to another because it is dependent upon so many factors —natural resources, training, past experience, capital equipment, markets, and the like. Unless artificially diverted, therefore, labour will tend to find employment in those occupations in which its productivity is the highest—

> If a country has a number of important industries of high productivity, able to pay good wages yet hold their own in the markets of the world, these industries set a standard of wages which other industries in the country must follow. If there are other industries which cannot produce as cheaply as their rivals abroad, if they have to pay those wages, then under conditions of Free Trade those industries will not be maintained in that country. This does not mean that the country will do without the commodities which those industries would have made, it will simply make more of the things that it can make best, and use part of them to buy from abroad what it cannot make quite so well[2]

[1] "British and Belgian Steel Wage-Costs," *The Economist*, 9th May, 1931.

[2] Sir William Beveridge, *op. cit.*

Where protective duties are employed for the purpose of counterbalancing other countries' lower costs of production, irrespective of how these arise, then we have what amounts to a negation of the principle of the division of labour. Further, if generally applied, this practice would have pernicious effects not only on international trade, but also on all friendly intercourse between one nation and another. In order to be strictly logical in putting this principle into effect, each importing country would have to impose different rates of duty on the same article, according to its country of origin. This would obviously entail a very cumbersome system of Customs clearance which would have a prejudicial effect on foreign trade Over and above these difficulties we have the undeniable fact that any accurate comparison of international labour costs has so far proved impossible so that the tariff could at best be but a clumsy approximation.

BARGAINING TARIFFS. It has been said many times in recent years that although free trade may be highly desirable as an ideal, the nations of the modern world have shown themselves so reluctant to adhere to it, that we must shape our own policy accordingly. It is argued that a few free trade countries, isolated in a hostile protectionist world, are in a singularly vulnerable position when other nations persistently ignore the example set them, and continually heighten their tariffs. The advocates of protection consider that the only practicable line of procedure is first to impose a tariff and then employ this as a weapon to secure concessions from other countries. As was pointed out in the final report of the World Economic Conference, however, high tariffs imposed for bargaining purposes have frequently not resulted in adequate modifications, with the consequence that customs barriers have been left higher than before.

Moreover, this evil has become accentuated since the War by reason of the imposition of the *tarif de combat* with purposely inflated rates of duty for bargaining purposes The negotiations are not infrequently protracted, so that the growth of vested interests is sufficient to defeat the object of the tariff by refusing to allow the intended reductions to be made Equally dangerous is the employment of customs duties as a means of retaliation in the event of commercial negotiations failing. "For other countries to tax our exports to them is an injury to us and an obstacle to trade. For us to

TARIFFS AND THEIR OBJECTS

TARIFFS

- **Protective**
  - **Defensive**
    - **Safeguarding Duties**
      - (a) Protection of Important Industries, e.g. "Key" Industries, such as dyes, and fine chemicals, and "staple" industries such as iron and steel
      - (b) Protection of Exchange Position by checking the import of luxuries
      - (c) Protection of Social Conditions by checking the import of goods from low-wage countries or prison-made goods
    - **Anti-Dumping Duties**
      - (a) Prevention of Exchange Dumping by imposing a tax on goods from countries with a depreciated currency
      - (b) Prevention of Freight Dumping by imposing a duty on goods which are carried at low freight rates for export
      - (c) Checking Government Subsidies by imposing a duty to offset the amount of the subsidy
  - **Offensive**
    - **Bargaining Tariffs**
      - (a) To secure a reduction in the tariffs of other countries
      - (b) To secure political or economic concessions
    - **Retaliatory Tariffs**
      - (a) To offset the imposition of a bargaining tariff
      - (b) As a reprisal for unfair discrimination
- **Revenue**
  - Designed to yield the maximum revenue to the State and not to have a protective effect

A tariff may be defined as a systematic collection of duties imposed on goods passing inwards and outwards from a given territory. The broad basis of tariff classification rests upon the object of the tariff—whether it is required to have a protective effect or to yield a revenue. This division leads to a certain amount of overlapping, for a duty will often have a protective effect even when employed for revenue purposes, unless it is impossible to produce the commodity within the country, or an excise duty of the same magnitude is levied on the home production.

tax their exports to us is not a correction of that injury; it is just a separate additional obstacle to trade "[1] Such a measure is an act of economic war, and like all methods of warfare, it is very wasteful and liable to lead to all kinds of unfortunate consequences to one or both of the countries concerned as well as to third parties. Dr T. E. Gregory explains the loss arising from a retaliative tariff war as follows—

> It arises from the reduction in the aggregate income accruing to both countries through the additional impediment to trade If both areas have specialized their production in the expectation of normal trade relations, any new hindrances to trade which affect the exchange of goods consequently reduce the net income of both sides. To this standpoint it is no answer to say that both sides can make up the deficiency by stimulating their own production. For in so far as this enables the old output to be reached, it will still only be immediately at the cost of greater real effort so that the per unit return to effort is less; whilst, in any case, it does not invalidate the point that with freer trade relations *and* the new level of energy a still greater net income could have been enjoyed.[2]

Nevertheless, although an aggregate loss is suffered it does not follow that the burden of the loss may be equally distributed. If, of two countries, A and B, the first produces a commodity which can also be obtained from countries X, Y, and Z without great difficulty, whilst the second produces a commodity which can be obtained nowhere else, then, in the event of a tariff war, the bulk of the loss would fall on A. B could dispense with A's product and purchase it elsewhere, but A could not purchase from any other source. In all probability, the diversion of trade would inflict some loss on B, but the principal burden would fall upon A.

TARIFFS AND DUMPING. Tariff legislation has been frequently applied to the question of dumping, and its use has been still more frequently urged, though a remarkable lack of unanimity appears to exist as to the meaning of the term. In popular usage it may denote anything from a deliberate price discrimination between one national market and another to a sale of goods by a foreigner at a price which the home producer, no matter how inefficient he may be, considers to be too low. Following Professor Taussig, we may, however, define the process of dumping as "the disposal of commodities in a

[1] Sir William Beveridge, *op. cit.*
[2] *Tariffs. A Study in Method.*

CLASSIFICATION OF DUMPING[1]

Type	Cause
Sporadic Dumping	(1) Producers who have on hand unexpected surplus stocks which cannot be disposed of in the home market without drastic price reductions which may "spoil the market," will often dispose of them in distant markets at whatever prices they can get. (2) Such dumping may be unintentional as where an error is made in contracting which leads to a sale of goods at an uneconomic price.
Short-term Dumping	(1) Dumping may be engaged in for a time in order to develop or conserve foreign markets by using low prices to introduce the product into a new market, or to extend the acquaintance with it. (2) Dumping may take place, though it involves a temporary loss, in order to drive a competitor out of a foreign market (predatory dumping). This may also take the form of defensive dumping where a producer sells at an unprofitable price in order to prevent himself being driven out by a competitor. (3) Such dumping may be provoked as a measure of retaliation against dumping in the reverse direction.
Long-term Dumping	(1) Dumping may be engaged in because the increase of sales resulting from it makes possible an enlarged scale of production for the entire output, including that portion marketed at home at the maximum price. For industries subject to marked economies of large-scale production, particularly where the domestic demand is inelastic, continued dumping may be profitable. (2) Dumping may be engaged in because the domestic price is a monopoly price sheltered by a tariff, and the maximum price at which export sales can be made, though lower than the domestic price, yields a net profit on its own account. (3) Dumping may occur because of the existence of a system of bounties or subsidies devised to encourage production and export. In such a case the price may be lowered by any amount not exceeding the bounty. (4) If the margin of profit is sufficiently great, a foreign producer may pay a protective duty himself and be content with a narrower margin of profit rather than attempt to raise prices against his overseas customers. Such cases are, however, very infrequent.

[1] Based on the classification of Professor Jacob Viner in *Dumping: A Problem of International Trade.*

foreign country at one price, and to domestic purchasers at another and higher price."[1] Although the term dumping is usually applied to price discrimination in international trade, it does not differ in kind from similar discrimination practised by manufacturers and traders in the home market. In the coal trade, for example, it is frequently said that consumers located in a mining area pay more for their coal than those located outside the district, the reason being that in the first case one producer supplies the market and there is no competition, whereas in the second, a number of producers are competing for the market. Hence there is price discrimination in favour of the competitive market which constitutes a type of dumping. Yet, as Marshall has pointed out, "It is obvious that international dumping is more likely when once detected, to be proclaimed aloud; it seems probable, therefore, that domestic dumping is at least as large in the aggregate as international, though opinions differ greatly as to the extent of each; and it is certain that the main incentives to dumping, and the technical problems raised by it, are substantially the same in domestic and international trade."[2]

The impression is frequently created at the present day that dumping is a special form of tactics recently adopted by the foreigner for the express purpose of ruining the British producer. Yet in the past there is ample evidence to show that British manufacturers and merchants have been guilty of the practice—indeed, if we were to accept some of the definitions of dumping which have been current recently, the whole of our overseas trade has been based upon the policy. It has a somewhat chastening effect when we read that "upon the adoption of the first tariff law in the United States in 1792, the merchants of Manchester contributed $250,000 to be invested in goods, to be sold in the markets of the United States at low prices, or to be given away if necessary, in order to discourage the investment of capital in manufacturing."[3] Such a process, it has been argued, is going forward to-day at the expense of the British producer. Prior to the passing of the Import Duties Act, 1932, it was said that foreign iron and steel producers, for example, were dumping material in this country in order to put British makers out

[1] *Principles of Economics* (Vol. I)
[2] *Money, Credit, and Commerce.*
[3] List, *National System.*

of existence. When they had achieved their object they would then exploit the British steel user, who was misguidedly buying their goods, by raising prices against him. Such an argument cannot be taken very seriously, and it is certain that the steel users have shown themselves more concerned about the immediate difficulties which confront their business due to the imposition of a tariff on imported steel, than with a problematical foreign steel monopoly in the distant future.

To make it worth while for manufacturers in a country A to dump goods in country B in order to kill the domestic manufacturers there and then raise prices, they must be sure of a monopoly in B when they have accomplished their object. If a third country C is still in the field, the manufacturers of A, when they have killed those of B by a costly price war, will not be in a position even to recoup their losses by extorting monopoly prices in B. As soon as they try raising prices above a fair level, the manufacturers from C will come into the market. In other words, determined predatory dumping will only be worth while for manufacturers who already have in hand or in prospect a monopoly, not in their own market alone, but in all the world outside the country where they dump [1]

Most countries have made use of "anti-dumping" legislation, particularly since the War. In this country, for example, the Safeguarding of Industries Act, 1921, provided for the imposition of a duty of 33⅓ per cent *ad valorem* on the importation of goods of any description, other than articles of food or drink, manufactured in a country outside the United Kingdom, where it is shown that such goods are being offered for sale in the United Kingdom at prices below the cost of production in the country of origin More recently, in 1931, we had the imposition of the Abnormal Importations Act, which was framed with the object of checking the "dumping" of foreign goods in an attempt to forestall a tariff. This measure revealed most of the defects of such anti-dumping legislation. In a critical analysis of the duties imposed under the Act, the *Economist* pointed out that certain of the goods taxed showed no signs of "abnormal" importation, whilst in other cases where this was in evidence, it was undoubtedly provoked by the uncertainty created by the Act and the manner in which its provisions were being applied by the Board of Trade. Further, it was argued that the rate of duty applied, namely, 50 per cent, was high without being prohibitive,

[1] Sir William Beveridge, *op cit.*

and in consequence left everyone in doubt as to our future tariff policy. Moreover, the method of procedure adopted was such as to afford the maximum of uncertainty both to British manufacturers and to foreign traders, since duties could be imposed at any time without preliminary warning. This Act was a temporary measure, and the duties are now fixed under the Import Duties Act, 1932.

THE BRITISH TARIFF SYSTEM. Although, until the autumn of 1931 we were accustomed to describe Great Britain as a free trade country, in actual fact we had, for a number of years, departed from the strict observance of the principles of free trade, and the most that we could claim was that we were imposing fewer restrictions upon the free flow of trade than the majority of other countries. In consequence, the Committee on Industry and Trade, writing in 1929, could say that, "So far as concerns artificial obstacles, we find on the evidence before us that with very few exceptions the free flow of materials of industry to our ports is not to any substantial extent obstructed by artificial obstacles, such as tariff duties or customs restrictions either in this country or in the countries from which we draw our supplies." In pre-war days, the few duties which were imposed on imports were purely financial in their nature—such as those on alcohol, tea, coffee, and cocoa—and were linked with an equivalent excise duty when appropriate. In the early days of the War, however, the advocates of protection began to make headway when there was a great demand for revenue, and a considerable shortage of shipping. As a result, in 1915, a series of duties was imposed under the Finance (No. 2) Act, generally known as the McKenna duties, upon such articles as clocks and watches, motor cars and their accessories, and on photographic films. These duties were not applied for protective purposes, but on account of the need for maintaining the stability of the foreign exchanges and for cutting down, as far as possible, expenditure on imported luxuries. The duties were renewed annually during the succeeding eight years, but were allowed to lapse in 1924. They were re-imposed in 1925 on the ground that the circumstances which first rendered them necessary were still present, and in 1926 they were extended.

In 1921 the demand for the protection of "key" industries received attention under the Safeguarding of Industries Act. As stated in the preamble, the Act was devised "with a view to the

PRINCIPAL TARIFF MEASURES INTRODUCED IN GREAT BRITAIN SINCE THE WAR

Designation of Duty	Description	Types of Commodities Affected
Budget Duties	These duties are imposed purely for revenue purposes, and almost all are specific duties. They are coupled with an equivalent excise duty whenever appropriate and have little protective effect.	Alcohol, tobacco, sugar, coffee, cocoa.
McKenna Duties	Imposed during the War to check dealing in luxury articles and to correct adverse exchanges. In these cases no corresponding excise duties were imposed and the duties have a pronounced protective character.	Motor vehicles, accessories and parts; musical instruments, clocks and watches; cinematograph films
Key Industry Duties	These were designed to secure adequate protection in this country for the production of certain articles which were regarded as vital to national safety in time of war, or of outstanding importance to industry. Under the Finance Act of 1926 the duties are continued until August, 1936.	Optical and scientific instruments; wireless valves; synthetic organic-chemicals; compounds of the rare earth metals; laboratory glass and porcelain ware, etc.
Safeguarding Duties	These were imposed originally under Part II of the Safeguarding of Industries Act, 1921, and subsequently by Finance Acts in accordance with a policy laid down in 1925, which provided that in certain circumstances duties might be imposed in cases where industries in this country were suffering from severe competition from abroad. The last of these duties is due to expire in 1933.	Fabric gloves and glove fabric; illuminating glassware; lace and embroidery; cutlery and buttons; packing and wrapping paper, etc.
Abnormal Importations (Customs Duties) Act, 1931 ——— Horticultural Products (Emergency Customs Duties) Act, 1931	These measures were intended to check abnormal importations prior to the introduction of a tariff, and in so doing to strengthen the exchanges. The duties imposed under the first measure were all at a flat *ad valorem* rate of 50 per cent. The duties on horticultural products were specific. Both measures were temporary; the operation of the first was superseded by the first Order made under the Import Duties Act, 1932, whilst the second expires in December, 1932, unless revoked.	These measures applied to a wide range of goods enumerated in Orders made by the Board of Trade.
Import Duties, Act, 1932	A measure introduced with a view to restricting in the national interest the importation of goods into the United Kingdom, and for providing a remedy in case of foreign discrimination. The operation of the measure is supervised by a Tariff Commission.	All commodities are subject to a 10 per cent duty except certain enumerated goods. Additional duties are imposed upon recommendation of the Commissioners.

safeguarding of certain special industries and the safeguarding of employment in the United Kingdom against the effects of the depreciation of foreign currencies and the disposal of imported goods at prices below the cost of production." The Act was divided into two parts, the first of which was concerned with the protection of key industries, including such products as optical glass, scientific apparatus, and chemicals. The second part of the Act established a procedure for safeguarding British industries of substantial importance which were suffering from unfair competition arising from one or more of the following causes—

1. Depreciation of currency operating so as to create an export bounty.

2. Subsidies, bounties, or other artificial advantages.

3. Inferior conditions of employment of labour, whether as respects remuneration or hours of employment, or otherwise, obtaining amongst the persons employed in the production of the imported goods in question as compared with those obtaining amongst persons employed in the production of similar goods in the United Kingdom.

In 1925 the Government laid down a new procedure for administering the provisions of the Act. The Board of Trade was given power to appoint committees to consider applications from industries threatened by unfair competition In making its decision the committee had to take into consideration the importance of the industry, the nature and extent of the competition to which it was subjected, the possible effects of a duty on industries using the goods, and the efficiency of the industry applying for protection. A number of duties were imposed under the provisions of the Act, such as those on lace, embroidery, gloves, incandescent mantles, and packing paper.

Under the stress of the economic crisis of 1931, the British Government introduced the emergency legislation designed to check "abnormal" importations, upon which we have already commented. The framework of what many are regarding as a "permanent" tariff system was laid down in the Import Duties Act, 1932. Under the provisions of this Act all imports were, from the 1st March, 1932, subjected to a tariff of 10 per cent, with the exception of certain enumerated commodities and also those already chargeable with duty under some other Act. For the purpose of giving effect to the

Act, an Import Duties Advisory Committee consisting of three members has been appointed. The general instructions to the Committee which has power to summon witnesses or require the submission of such returns or other information as it needs, are as follows—

(1) Where it appears to the Committee that an additional duty of customs ought to be charged in respect of goods of any class or description which are chargeable with the general *ad valorem* duty and which, in their opinion, are either articles of luxury or articles of a kind which are being produced or are likely within a reasonable time to be produced in the United Kingdom in quantities which are substantial in relation to United Kingdom consumption, the Committee may recommend to the Treasury that an additional duty ought to be charged on goods of that class or description at such rate as is specified in the recommendation

(2) In deciding what recommendation, if any, to make for the purposes of this section, the Committee shall have regard to the advisability in the national interest of restricting imports into the United Kingdom and the interests generally of trade and industry in the United Kingdom, including those of trades and industries which are consumers of goods as well as those of trades and industries which are producers of goods.

Any additional duty recommended by the Committee may be imposed by Treasury Order, subject to the right of veto of Parliament within twenty-eight days. Until November, 1932, or such further date as Parliament may determine, goods from the countries of the Empire are exempt. The Board of Trade is also given power to impose a special surtax up to a maximum of 100 per cent *ad valorem* upon imports from countries which discriminate against the importation of British goods, or those from Crown Colonies or British Mandated Territories. It has been repeatedly stated that it is the intention of the Government to employ the Act to facilitate the lowering of tariff barriers in foreign countries by offering to reduce our own in return. The initiative for such negotiations lies with the Board of Trade and, on a recommendation from the Board, the Treasury will have power to revoke or reduce the duty on any goods from such a country.

It is impossible at this stage to attempt to assess the effects of the new British tariff on the future course of British industry and trade. The factors which require to be given consideration are too many and too indeterminate. The future course of internal prices, for example, depends upon the movements of gold prices as well as on

the monetary policy of the British Government, so that any movement of domestic prices may have no necessary relation with tariff policy. Again, in considering the Act, very much depends upon the manner and the spirit in which its proposals are put into operation. There is nothing inherent in the Act itself to prevent the worst abuses of tariff-making being repeated in the case of this country. As the *Economist* pointed out in the course of a critical review of the new duties, "The test of the present policy will come when the Government starts to deal with foreign countries, for it will justify itself only if the protective demands of British industries can be suppressed and our tariff used to lead the world back towards something like free trade. As the tariff stands at present, we are in danger of combining the extensive plan of taxing almost everything with the very dangerous game of imposing high protection on finished goods for the benefit of home producers. If we drift along much farther in this direction we shall find that we have got the worst of both worlds."

TEST PAPER 11

1. "In the sphere of international trade, as in other branches of economic life, Governments have sought to control the free play of economic forces." Give two illustrations of the truth of this statement.
2. Write brief explanatory notes on the following—
   Import and Export Prohibitions.
   Import and Export Licences
   Quotas
3. State three reasons which may be advanced in support of tariffs.
4. Draw the diagram on page 291 and explain its meaning.
5. What is meant by "anti-dumping" legislation?
6. What are the various objects for which duties are imposed upon certain articles imported into this country? Illustrate your answer by referring in detail to tobacco, sugar, wine and spirits, and motor cars, showing how far you consider the objects are achieved in these cases.

CHAPTER XII

Foreign Exchange

Amongst the simplifications which were introduced when dealing with the subject of foreign trade was the supposition that no money was employed, but that goods were exchanged against goods by a process of barter. But virtually all trade is carried on through transactions between individuals in terms of money, and, in the ordinary course of things, there is no conscious exchange of goods for goods. This is true of international as well as of domestic trade, so that when we buy foodstuffs or raw materials from abroad, our currency has to be exchanged for the currency of the country in which the seller wishes to be paid. It is through the machinery of the foreign exchanges that the international indebtedness arising from foreign trade and other causes is settled in the most economical manner. Now it will need no lengthy exposition to show that the settlement of international transactions is a more complicated matter than those arising from purely domestic business. National currencies are widely diverse in their nature, so that it becomes necessary to convert pounds sterling into francs, dollars, or lire, as the case may be, in making payment. Since the majority of currencies are linked in normal times in some way or other with gold, this metal serves as a common denominator of international values. Hence, it would be possible to effect the payment for foreign goods by the transmission of an equivalent value in gold, and, indeed, this method is occasionally adopted. As a general method, however, it would be both clumsy and expensive, so that what is required is a method of facilitating settlements which, at the same time, reduces the transport of gold to a minimum. Herein lies the function of foreign exchange in applying the machinery of credit to the settlement of international transactions.

Mechanism of Foreign Payments. Let us commence by stating an imaginary case. Suppose a certain merchant, A, in London sends goods valued at £100 to B in Paris, and, on the same day, D in Paris also sends a consignment valued at £100 to C in

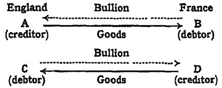
London. Unless some contrivance intervenes, B must send £100 in bullion to pay for the goods that he has received, whilst, at the same time, £100 worth of bullion will be consigned by C to D in order to pay for the French goods which have been imported. Clearly this involves a waste of time and invites risks which should be avoided. In domestic trade this difficulty is overcome by the cheque system and the Bankers' Clearing House. We, therefore, need some similar device in foreign trade which will enable debits and credits to be set off against each other. This is found in the foreign exchange, which is nothing more than a system by means of which debits and credits which are close together are made to settle debits and credits which are far apart.

At the root of the whole process lies that instrument of credit known as a bill of exchange. In the somewhat forbidding terminology of the Bills of Exchange Act, 1882, which regulates the use of these documents in this country, the instrument is defined as "an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a sum certain in money to or to the order of a specified person or to bearer." Let us see how the bill of exchange is employed in practice. When A, in London, consigns his goods to B, in Paris, he draws a bill upon B for £100 and this he sends across to B, who accepts it by writing his name across it and then returns it to A. On the same day, D, having sent goods to C, draws upon him for £100, and this bill is also accepted. Hence, the position now is that A, in England, has a French bill for £100, and D, in France, has an English bill for the same amount The question arises, cannot some means be devised whereby one transaction will cancel the other? Let us suppose that C, instead of accepting a bill drawn on him by D, gets into touch with A, who holds a French bill from B, and buys this from him for £100. The position now is that A has parted with his goods to B in return for the bill, and this latter he has now sold to C for £100, so that, so far as A is concerned, the transaction is complete, whilst B's indebtedness is, in effect, transferred to C. If C now sends this bill to D it will also cancel the debt between them, as D now holds B's bill and will look to him for payment. Since both D and B are in France, the payment of the bill presents

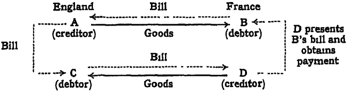
no greater difficulties than any other settlement which may be made in the home trade.

DIAGRAMS ILLUSTRATING THE SETTLEMENT OF TRANSACTIONS IN OVERSEAS TRADE

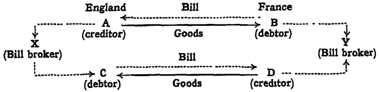
I. Trade before the Introduction of Bill of Exchange



II. Trade after the Introduction of Bill of Exchange



III. Trade showing Intervention of Bill Broker



We cannot be sure, however, that C is acquainted with A, whilst in any case it is unlikely that the bill would be exactly for the amount required. The fact is that on each side there will be a third person, whom we might call X in England and Y in France, who deal in bills and are known as bill brokers. Thus, when A receives B's bill in payment for the goods, he will not usually keep it but will sell it to X, and C, who is in need of a French bill, will go to X to buy one Upon receiving the bill from C, the Frenchman D will probably sell it once more to Y in order to obtain cash, and the latter will collect the proceeds in due course from B.

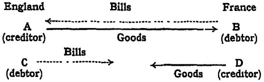
BASIS OF EXCHANGE RATES. So long as there is an equality of goods passing between England and France, the bills between the two countries will be sufficient to satisfy the needs of the merchants on both sides. The supply and demand on each side will be equal, and, ignoring for the moment differences in currency units, the value of a £100 bill would be the same in both countries. In other words, we say that the exchanges would always be at par—there would be an equivalence of indebtedness. This hypothetical par of exchange is merely an academic abstraction, since the balance of indebtedness between two countries is never equal. Suppose, now, that exports and imports between the two countries are unequal—that England sends more goods to France than the latter sends in return. Then the supply of French bills in the hands of English bill brokers will be greater than the demand for them on the part of importers of French goods, whilst in France the demand for English bills will exceed the supply. Now the price of bills, in common with that of everything else, depends upon the relation existing between demand and supply. When the supply of bills is plentiful in relation to the demand for them, the price will tend to fall, and when the converse conditions hold good, it will tend to rise. In London, therefore, where French bills are plentiful and the exchange is favourable to this country, the rate is said to be at a *discount*. In France, on the other hand, where the exchange is unfavourable, the rate is said to be at a *premium*.

As already pointed out, the hypothetical par of exchange is useless as a basis of exchange rates. The basis which has been adopted is known as the *Mint Par of Exchange*, which has been defined as "the exact equivalent of the unit of currency of one country, expressed in terms of the currency of another, based upon the quantity and fineness of the metal contained in the two coins as fixed by law." As between countries on the gold standard, therefore, the mint par of exchange represents a central point about which the rates of exchange between any two countries will fluctuate. It is a comparison of the value of the units of two currencies on the basis of the amount of gold to which their possession entitles the owner. In pre-war days, with the currencies of most of the important nations of the world based upon a gold standard, the actual exchange rates never deviated far from this point, and the

limits of fluctuation were fixed by what are known as *gold points*, and depend upon the cost of sending gold from one country to another.

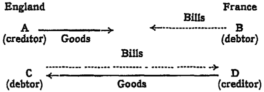
DIAGRAMS ILLUSTRATING THE FORMATION OF RATES OF EXCHANGE

I. Exchange Favourable to England



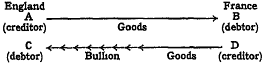
French bills will be plentiful in England and, therefore, cheap, whereas English bills will be scarce in France and, therefore, dear. The exchanges will move in favour of England.

II. Exchange Unfavourable to England



The reverse position now obtains and the exchanges will move in favour of France.

III. Exchanges Tend to Par



In order to restore equilibrium France must, in case I, export bullion in settlement of the adverse balance, whilst in case II, England must do the same.

By way of illustration, let us revert to our example of trade between England and France. We saw that there was a shortage of English bills in France, so that the demand for them forced up the price. What limiting factor, if any, is there to this rise in price? Assuming a free gold market, a French importer, as an alternative to sending a bill, may export bullion in settlement. On this he will

have to pay freight and insurance charges and, if we assume that these amount to 1 per cent, then he will have to disburse £101 in all to settle the debt. It will, therefore, pay the French importer to give anything up to £101 for a £100 bill, but beyond this point he will not go, as it will be cheaper to send bullion. If, however, the exchanges are in favour of France, the value of the pound will fall in terms of the franc, but it will fall only to gold import point to France, when bullion will move from England to France

The gold point theory, which, in pre-war days, depicted with fair accuracy the relations existing between the principal monetary centres of the world, no longer has any considerable application. In the first place, it depends for its operation upon a free gold market, and the number of such centres is limited. Again, for reasons which we shall discuss below, other factors now operate to obscure gold points and rob the whole process of its former certainty.

CALCULATION OF THE MINT PAR. The Mint Par is a comparison of the values of two currencies on the basis of the amount of gold to which their possession entitles the holder. It follows that, if we know the mint laws of any two gold standard countries, it is possible to ascertain the Mint Par between them. The Mint Par between England and the United States may be taken as an example, the regulations being—

(*a*) *England*—one sovereign weighs 123·27447 grains of gold $\frac{11}{12}$ fine

(*b*) *United States*—the eagle of ten dollars weighs 258 grains of gold $\frac{9}{10}$ fine

The data may be arranged in a set of simple equations as follows—

(1)	x dollars	= 1 sovereign
(2)	1 sovereign	= 123·27447 grains standard gold.
(3)	12 grains standard gold	= 11 grains fine gold.
(4)	9 grains fine gold	= 10 grains standard gold (U S.A.)
(5)	258 grains standard gold (U S.A.)	= 10 gold dollars.

Now the above columns contain two sets of items, of which every one in the left-hand column is equal to a corresponding item in the right-hand column It follows that if all the items in the first column are multiplied together, the result will be equal to the product of all the items in the second column, thus—

$$x \times 1 \times 12 \times 9 \times 258 = 1 \times 123{\cdot}27447 \times 11 \times 10 \times 10$$

$$\therefore x = \frac{123{\cdot}27447 \times 11 \times 10 \times 10}{12 \times 9 \times 258}$$

$$= 4{\cdot}8665$$

The Mint Par = 4·8665 dollars per £.

EXCHANGE RATES. A list of foreign exchange rates is published daily in most newspapers on the lines of the abridged table given below which shows rates in force before Great Britain suspended the gold standard. The first column of the table indicates the foreign centre upon which the rates are quoted, whilst the second column tabulates the method of quoting. It will be noted

LONDON RATES OF EXCHANGE

Centre	Method of Quoting	Par of Exchange	22nd July	21st July
New York .	Dols. to £	4·86$\frac{2}{3}$	4·84$\frac{1}{8}$–84$\frac{1}{4}$	4·84$\frac{3}{4}$–84$\frac{7}{8}$
Montreal . .	Dols. to £	4·86$\frac{2}{3}$	4·86$\frac{1}{8}$–86$\frac{3}{8}$	4 86$\frac{3}{8}$–86$\frac{5}{8}$
Amsterdam . .	Fl. to £	12·107	12·03$\frac{1}{4}$–03$\frac{3}{4}$	12·04$\frac{1}{4}$–04$\frac{3}{4}$
Berlin .	Mks. to £	20·43	20$\frac{1}{2}$–21†	20$\frac{1}{2}$–21†
Brussels . .	Belg. to £	35	34 78–34·79	34·80$\frac{1}{2}$–81$\frac{1}{2}$
Copenhagen . .	Kr. to £	18·159	18·16–18 17	18·16$\frac{1}{4}$–17
Madrid . .	Pts. to £	25·2215	52·55–52·65	52·45–52·55
Milan . .	Lire to £	92·46	92·60–92 70	92·78–92·82
Oslo . .	Kr. to £	18·159	18 16–18·17	18·16–16$\frac{1}{2}$
Paris . . .	Frs. to £	124·2134	123$\frac{3}{8}$–123$\frac{1}{2}$	123$\frac{5}{8}$–$\frac{3}{4}$
Stockholm	Kr. to £	13·159	18·13$\frac{1}{2}$–14$\frac{1}{2}$	18 14–14$\frac{1}{2}$
Zurich .	Frs. to £	25·2215	24·91–24·93	24·94–24·96
Bangkok*	Per Baht	21·82d.	21$\frac{3}{8}$d.	21$\frac{3}{8}$d.
Batavia* .	Fl. to £	12·107	12·07$\frac{1}{2}$	12·07$\frac{1}{2}$
Bombay . .	Per Rupee	18d.	17$\frac{13}{16}$–$\frac{27}{32}$d.	17$\frac{13}{16}$–$\frac{27}{32}$d.
Calcutta . .	Per Rupee	18d.	17$\frac{13}{16}$–$\frac{27}{32}$d	17$\frac{13}{16}$–$\frac{27}{32}$d.
Hong Kong* . .	Pence to $	—	11$\frac{7}{8}$–12$\frac{3}{8}$d	11$\frac{7}{8}$–12$\frac{3}{8}$d.
Kobe . .	Per Yen	24·58d.	24$\frac{3}{8}$–$\frac{7}{16}$d.	24$\frac{11}{32}$–$\frac{13}{32}$
Manila* . .	Pence to $	24·066d.	24$\frac{5}{16}$d.	24$\frac{5}{32}$
Saigon* . .	Per Pst.	—	19$\frac{3}{32}$d.	19$\frac{3}{32}$d.
Shanghai*	Per Tael	—	14$\frac{7}{8}$–15$\frac{3}{8}$d.	14$\frac{7}{8}$–15$\frac{3}{8}$.
Singapore* .	Pence to $	28d.	27$\frac{11}{16}$–$\frac{13}{16}$d.	27$\frac{11}{16}$–$\frac{13}{16}$d.

* Rate quoted on London. † Nominal.

(Taken from the *Financial News*)

that there are two methods of quoting, either so many units of the foreign currency to the pound sterling, as is the case with the rates of New York and Berlin, or, alternatively, so many pence per foreign unit, as is the case with the Hong Kong rate. When prices are quoted in the former manner, a rise in the rate quoted for sterling will indicate a condition of things in favour of the English buyer of foreign currency. It is better for us to get 124 francs for our

pound than only 123. On the contrary, when the second method of quoting is adopted then low rates will be favourable and high rates unfavourable, for in the one case it will take less pence to buy the foreign unit, and in the other, more pence. The third column gives the mint par of exchange, which we have already discussed, and it will be noted that, in the case of centres in China, no figure is given, as the currency is on a silver basis.

Coming now to the quotations themselves, two days' rates are given for purposes of comparison, and, more important, a double quotation is given in each case, representing buying and selling prices. The precise significance of the figures varies with different newspapers. *The Times* gives figures representing the highest and lowest rates offered on the day in question; the *Financial News* and *Morning Post* give the closing rates for buyers and sellers. The difference between the two rates represents the margin for dealing between the banks and the foreign exchange brokers in London, and the real or trading quotation will lie somewhere between the two.

Cable Rates. The actual transfer of money abroad is made by cable. The bank in London, acting upon the instructions of its customer, cables its foreign correspondent asking him to pay the required sum to the overseas creditor. The rates at which these transactions are effected are called cable or telegraphic transfer rates, and it is these which are usually published in the newspapers. The basis of this rate will be determined by the cost incurred by the banker in providing funds at the overseas centre. He may obtain such balances by the purchase of bills drawn on the foreign centre, or, alternatively, may buy bills drawn on a second centre and, with the funds produced by encashment there, purchase other bills drawn on the centre in which he really wishes to operate. He will employ either method in accordance with the dictates of economy. Only in the last resort will he ship bullion.

Cheque Rate. This is the rate at which a bank will buy bills or cheques payable at sight or on demand. Cheque rate is higher than cable rate because, in the first place, the bank may require a small margin as insurance against risk. Secondly, the bank pays sterling at once for the bill, but does not receive payment until it reaches its destination and is presented. When a foreign bill is not sold but

is handed to the London banker for collection, the customer has to wait for his money until the bill reaches the foreign centre and is paid. He gets sterling at the cable rate ruling on the day the bill is paid, less the charge made by his bank for the collection.

Long Rate. This is the rate at which a bank will buy foreign bills payable at some definite period after sight—usually three months. When such a bill is purchased, the bank pays sterling immediately, but will not receive the foreign currency until three months hence, or for the unexpired period of the bill. The buyer must, consequently, receive consideration for waiting, and, possibly, for risk. The long rate will, therefore, be based upon the cheque rate, due allowance being made for these factors, so that it will be the higher rate of the two.

Forward Rates. These are the basis of a special market which was built up to meet the difficulties arising from the unsettled exchange conditions of the post-war period. The essential feature of forward exchange is that a rate is arranged immediately for an operation to be completed at a future date. For example, an importer who knows that he will be called upon to pay a certain amount of a foreign currency at a definite future date, makes immediately a contract with his banker for the purchase of that currency at a fixed rate. In this way the merchant limits his liability to a definite quantity of sterling, whilst the bank has means not available to the merchant of reducing the liability of which it has relieved him. It may cover itself by buying forward, or by purchasing a long-dated bill on the foreign centre, maturing on or a little before the date of delivery of the currency. The rate charged for such transactions will depend partly upon the rate of interest prevailing in each of the centres, and partly upon the demand and supply of forward exchange. The psychological influence is also important—the expectations of dealers regarding the future course of the value of the currency.

GOLD POINTS. We have already seen in the course of our previous discussion that the influence of gold points in foreign exchange dealing have lost much of their old significance, and the return to the gold standard by the principal nations has not led to a restoration of pre-war conditions. One of the primary objects of the gold standard is to fix approximate limits to exchange fluctuations, so

that it should be possible to ascertain gold points with a high degree of accuracy. Yet, since the restoration of the gold standard, considerable uncertainty on this point has existed, even amongst the central banks themselves. Now, in the ordinary course, the gold point is far from being a fixed and invariable magnitude, but varies with the relative rates of interest ruling in different centres, and with the insurance and transport costs involved. For example, the transport of gold by air, which is becoming the chief method employed in Europe, has caused considerable reductions in transport costs, with the result that gold points have moved closer to one another and money markets lose gold more easily than was the case before the War.

It has been pointed out[1] that, under existing conditions, three sets of gold points exist. There is one set which will govern arbitrageurs who are paying interest on the shipment but no commission or brokerage, there will be an "extreme" gold point for those having to bear these charges, and, finally, there will be another for central banks paying no interest at all. In the case of a central bank, the holding of gold constitutes an idle reserve which earns no interest, and this is the case whether it is lying in the vaults of the bank or is in transit. In consequence, a central bank can undertake shipments before other members of the money market can do so. In the case of the banks, allowance must be made for these charges, so that the margin between the gold points in the case of a central bank is narrower than the margin for other banks. This would not matter very much but for the fact that there is no certainty in the mind of dealers in the money market whether or not gold will be shipped when the exchanges move beyond the special gold points of the central banks. In addition to this, however, it sometimes happens that the central bank brings indirect pressure to bear upon arbitrageurs with a view to preventing gold shipments, even though these be warranted by the position of the exchanges. A variety of means lies at the hand of the central bank for this purpose, such as the refusal to pack the gold, thereby putting the exporter to the additional expense of providing this service himself. Such tactics destroy the automatic working of the gold

[1] See *Economic Journal*, September, 1929, "Gold Points and Central Banks," by Dr. Paul Einzig

standard and infuse uncertainty in the minds of the business community.

PURCHASING POWER PARITY. During the War, when most countries departed from the time-honoured gold standard and issued inconvertible paper currencies, the old theories of exchange movements became inapplicable. In explanation of the new conditions, Professor Cassel advanced the Purchasing Power Parity theory, which, stated briefly, says that the normal rate of exchange between any two countries tends to settle at a point which expresses the relative purchasing power of the money of those countries. As applied to an inconvertible currency, the theory has been summarized by Mr. J. M. Keynes, in *A Tract on Monetary Reform*, as follows—

(1) The purchasing power of an inconvertible currency within its own country, i.e. the currency's *internal* purchasing power, depends on the currency policy of the Government and the currency habits of the people, in accordance with the Quantity Theory of Money (2) The purchasing power of an inconvertible currency in a foreign country, i.e the currency's *external* purchasing power, must be the rate of exchange between the home currency and the foreign currency, multiplied by the foreign currency's purchasing power in its own country. (3) In conditions of equilibrium the *internal* and *external* purchasing powers of a currency must be the *same*, allowance being made for transport charges and import and export taxes; for otherwise a movement of trade would occur in order to take advantage of the inequality. (4) It follows, therefore, from (1), (2), and (3) that the rate of exchange between the home currency and the foreign currency must tend in equilibrium to be the ratio between the purchasing powers of the home currency at home, and of the foreign currency in the foreign country. This ratio between the respective home purchasing powers of the two currencies is designated their "purchasing power parity."

The mint par is a comparison of quantities of gold, but the purchasing power parity is a comparison of certain kinds of commodity prices.

The theory still applies when the countries concerned are on a gold standard basis. The value of gold, in other words its general purchasing power, cannot vary to any considerable extent between two centres without causing a flow of gold from the point where it is less valuable to that where it is of greater value. In speaking of purchasing power in connection with this theory, we have to consider the price levels only of those goods entering into international

trade; goods and services for domestic consumption do not enter into the calculation. It will be the change in the price level of goods which enter into foreign trade which will determine whether gold will move to adjust differences. Secondly, due allowance must be made for transport charges, and import and export duties, as these, by restricting the free movement of goods, create artificial differences in price levels. Purchasing power parity is, therefore, a variable figure, changing with price levels.

TEST PAPER 12

1. Show how bills of exchange operate so as to bridge over time and space, and to facilitate exchanges between foreign countries.
2. "Foreign trade is really barter." Explain this statement, and describe the functions of money in international commerce.
3. Explain accurately what is meant by the Mint Par of Exchange, and show how fluctuations in the foreign exchanges may occur between two countries on the same standard.
4. What part do Bills of Exchange play in international trade? How is the price of a Bill of Exchange determined?
5. Distinguish between Par of Exchange and Rate of Exchange Explain why the Rate of Exchange is a variable rate.
6. "The amount of deviation from par of the chief European exchanges is a measure of the strength, either united or counteractive, of two distinct forces—relative indebtedness and the relative value of money." Expand and explain this statement.
7. What do you mean by the "Foreign Exchanges"? When is an exchange said to move in England's favour? Show that an unfavourable exchange is equivalent to a tax on imports.
8. How is the rate of exchange between England and France determined? What principal factors cause the rate to vary?
9. Explain the terms "favourable" and "unfavourable" in connection with the Foreign Exchanges, and also the saying: "high rates are for us, and low rates against us."
10. What probable causes set the exchanges between London and New York against London? By what means, and to what extent, can such unfavourable exchange be altered? What are its chief consequences to trade and industry?
11. In what sense and to what extent is it true to say that the foreign exchanges are "self-adjusting"? Illustrate from the present or recent movements of the exchange between London and any other centre.
12. What facts concerning the London-New York exchange would you deduce from a statement in the newspapers to the effect that a shipment of gold from the U.S.A. has been received at the Bank of England?

13. Explain what is meant by Gold Points. Discuss in your answer whether actual rates of exchange ever rise above or fall below specie or gold point.
14. Explain the working of the Gold Point Theory of the exchanges, contrasting pre-war and post-war conditions.
15. Give a critical account of the Purchasing Power Parity Theory of the foreign exchanges.

CHAPTER XIII

FINANCIAL CRISES

ECONOMIC activity is directed towards the production of goods and services which will satisfy human want. Now, human wants in respect of certain types of goods are fairly constant, as is the case with the necessities of life—food, clothing, and shelter—but with the advance of civilization the range and complexity of wants increase. This raising of the standard of life is, however, a comparatively slow process, so that one might expect that any changes to which it might give rise would easily be made. Further, the growth of population causes an increased demand for goods, but here, again, the process takes place so slowly that it might be assumed that adjustment would be a relatively simple matter. In practice, we find that the course of industrial production shows no such stability, and that, quite apart from natural causes outside the control of man—such as earthquakes causing the destruction of wealth, or fine weather causing an exceptionally good harvest—the whole trend of economic production is subject to violent fluctuations. Modern communities find themselves placed in circumstances which have called forth scathing criticism from social reformers. We see the spectacle of a nation with a large amount of productive equipment standing idle, capable of turning out large quantities of economic goods, whilst, on the other hand, we have hundreds of thousands of people seeking vainly for work and in desperate need of these same goods. At one time, we find the industries of a country working at high pressure, turning out a constant stream of goods, which are promptly absorbed by consumers. A few years later, these same industries are in a languishing condition with few orders.

The consumers may be still there and so is the productive equipment, but something has occurred to upset the working of the economic process.

This phenomenon, known as the Trade Cycle, has attracted an increasing amount of attention in recent years, but, despite the large amount of research which has been directed to the problem, it still

remains one of the unsolved mysteries of economics. The trade cycle relates not to a particular industry, or even to a group of industries, but is a phenomenon which affects economic activity as a whole. In the very nature of things, progress must bring change, so that at any given moment certain industries will be expanding whilst others are declining. Thus, the rayon industry, which, in the Census of Production in 1907, was of such minor importance that its output was not shown separately from that of real silk, increased its production sevenfold between 1912 and 1924 On the other hand, the development of loose-leaf ledger systems, and the mechanization of the book-binding industry, has considerably changed the nature of the trade and restricted its activities in certain directions. In other cases, again, an industry may decline and then undergo enormous expansion as the result of some new discovery. The gas industry, for example, declined when first faced with competition from electricity, but with the invention of the incandescent burner, took a new lease of life. Such fluctuations as these cover but a restricted portion of the industrial field and are inseparable from economic progress. But the trade cycle is widespread and, although its incidence may be unequal, its influence is practically universal since, if it does not create actual depression in any particular case, it probably retards progress.

COMPLEXITY OF ECONOMIC ORGANIZATION. The predominating characteristic of modern industry and commerce is specialization, but this, of necessity, involves a high degree of interdependence. The mere fact that one person or one business enterprise concentrates upon a single stage of production implies that someone else is engaged upon the preceding and the subsequent stages of the same process. More than this, it implies that others, again, are catering for the needs of the first set of producers. No industrial series is self-sufficing That sequence of industrial units which constitutes what we term the "Cotton Industry"—the Liverpool Cotton Market, spinning section, weaving section, finishing, packing, merchandising—is in its turn dependent on other similar chains of enterprises for its needs, such as buildings, machinery, fuel, transport, professional services, and the like.

Broadly speaking, this interdependence of economic organizations is of a threefold nature. There is what might be termed

technical interdependence—the close relationship which exists between a chain of business undertakings, each performing one stage of production in an industry. Thus, we have the chain already mentioned constituting the cotton industry, or, again, we have another chain termed heavy engineering—iron and steel works, rolling mills, engineering works—whilst these two series intersect in a specialized textile engineering branch. But apart from technical interdependence, there is a second tie of even greater importance, that of commercial relationships. The movement of goods between one section of an industry and another, or from one industrial group to another, is brought about by a series of commercial contracts for the purchase and sale of goods. Every business undertaking stands in this twofold relationship; to one section of the business community it is a source of supply, to another it represents a market. It follows, therefore, that a setback in one portion of the industrial field is likely to find speedy reflection elsewhere. The complicated system of credit upon which so many important transactions are based makes a disaster to one unit a menace to many others.

In addition to these commercial ties with concomitant financial obligations, we may recognize a further set of relationships which are purely financial in origin. The joint-stock form of organization which is typical of modern business, lends itself to a close interlocking of interests. Not only may one individual hold shares in a large number of undertakings, but one business can hold some or all of the share capital of another. Thus we find a network of interconnected financial interests of extreme complexity—the Royal Mail group in the shipping industry constitutes a notable example of this tendency. In another sphere we find the Unilever combine, with its international ramifications and elaborate financial connections. In this business, which constitutes one of the biggest amalgamations in European history, there is brought under a single direction, so far as trading policy and finance are concerned, a group of companies performing a wide range of functions, extending from the production of vegetable oils in the Tropics to the catching of whales in the Antarctic; from the manufacture and marketing of margarine, soap, perfumes, and cattle foods, to the retailing of groceries and the keeping of fish shops and restaurants. In speaking

of such webs of financial relationships, Dr. Wesley C. Mitchell, in his work *Business Cycles*, says—

> The tangle of financial relationships among business enterprises which has arisen from the prevalence of corporate organization is so complicated that it never has been, and perhaps cannot be, adequately represented in figures. Many corporations are owned, in whole or in large part, by some parent company or holding concern. In other cases, formerly independent enterprises have cemented a financial alliance by exchanging stocks. In still other cases, two or more companies are owned largely by a common group of stockholders. Some of these financial bonds are close and permanent, others are loose and shifting. The reasons for the financial alliance, whatever its form, are sometimes far from obvious—business makes strange bedfellows as well as politics. The alliance may be used to safeguard the interests of all the participants, or it may result from and be used to enhance the power and profit of some preponderating interest.

In addition to its specialization, with the interdependence of its branches, a further characteristic of modern industry is the fact that it produces for a market in anticipation of demand. In a complex system, such as that which we have described, no single undertaking can afford to wait for actual orders before commencing production. To take one example, the world cannot afford to wait for ships to be constructed when it has large stocks of raw materials and foodstuffs awaiting transportation. The construction of a large steamship may take anything from twelve months to two years, so that it will be evident that building must be commenced at least this time ahead of anticipated demand. Prior to this, the iron and steel works, engineering factories, and all the other adjuncts of shipbuilding must contribute their quota of supplies—so that the whole chain of production may stretch over a considerable period of time. The same phenomenon may be observed in every industry working on modern lines, though the process may not be of such long duration. The point now arises that production undertaken in advance in this way is utterly useless and wasted if the demand fails to materialize. Every entrepreneur must forecast the future trend of markets, and the degree of accuracy of his forecast will serve as a measure of his success in business. His forecast will have to give consideration to two elements—the nature of the goods which he considers will be required, and the quantity of them which will be demanded, though the relative importance of these two

factors will vary with the nature of the industry in question. In certain branches of production making those types of goods which are counted as necessities, it is known that a demand for the product must exist, but the problem of the magnitude of this demand remains to be solved.

When, however, we come to consider the "luxury" articles, we are confronted by the double problem of what to produce and the quantity which the market will absorb. It is in this class of production that we find the competition of one industry against another, even though they be dissimilar in their nature. The market for wireless sets may expand at the expense of that for gramophones; rayon products may displace the finer counts of cotton goods, whilst the caprice of demand may, in a very short time indeed, convert a prosperous industry into one which is declining. Hence the uncertainty of demand, which is felt in every branch of industry to some extent, accentuates economic instability.

When, therefore, we consider the ramifications of economic organization, and the fact that large numbers of entrepreneurs are working with but scanty knowledge of the plans of one another, it is not surprising that economic activity experiences fluctuations. There is no such thing as the "government" of industry, and "nothing but direct intervention of Providence would suffice to make production adjust itself perfectly and instantaneously to the world's needs." As one writer has said—

> This intricate system has been built and is maintained by the work of thousands of men, of keen but limited vision, each working within his own special sphere, each normally seeing and knowing only his own and the immediately adjacent territory. . . . Since the rude shock of war broke this machine the world has been looking for the supermen who made and controlled it, for those who understood it both in its basic principles and its infinite detail, and could therefore re-fashion and re-model it to the new conditions It has not found them. They do not exist.[1]

TYPES OF ECONOMIC FLUCTUATIONS. Fluctuations of economic activity are by no means uniform in their incidence, and, by an examination of the field of industry which they cover, we may recognize at least three types. As already pointed out, static conditions cannot prevail in industry for any length of time. Certain

[1] Salter: *Allied Shipping Control*

industries are expanding whilst others are tending to decline. Again, as it is with industries as a whole, so it is with the individual enterprises of which they are composed. New units are continually being brought into existence whilst others are eliminated, thereby causing an ebb and flow of economic activity which is purely local in nature.

More clearly defined than the foregoing are the seasonal fluctuations which are a well-recognized feature of certain trades. Detailed inquiry has shown that it is almost the exception rather than the rule for any trade to maintain fairly equable activity throughout the year The causes of these seasonal variations of activity have been ascribed either to climate or to convention. Thus, climatic control governs the periods of growth of crops, whilst, indirectly, it influences many branches of production by determining the clothes which we wear, our sports, the amount of fuel which we use, and the occupations which may be followed. A frequently quoted example of the influence of climate upon an industry is the case of the building trade, which, from December onwards, shows increasing activity, employment attaining to a maximum in August and thereafter steadily declining. Conversely, coal miners find their slackest period in the warmest months of the year. Conventional causes of seasonal fluctuations arise particularly in connection with recognized festivals and holidays. Hence, we find active retail buying before Christmas, or a boom in dressmaking in May and June at the height of the London season. It may be said that—

> There is, as the Board of Trade is able positively to testify, no month in the year in which some great industry is not at its very slackest, and equally no month in the year in which some great industry is not at its very busiest. Thus, taking the actual facts of the last ten years, whilst January is the slackest month in iron mining and the furnishing trades, it is actually the busiest at the docks of London and other ports (except those dealing with the Baltic), and one of the busiest for coal-mining, in February the plumbers have most unemployment, but the paper-making trade is at its briskest, in March and April the coopers are at their slackest, but the steel smelter and the great industries of the textiles and multifarious furnishing trades are busy [1]

Finally, we have fluctuations of a more widespread character and of longer duration, and it is to these alternating periods of general prosperity and general depression that the term "trade cycle" is

[1] *Seasonal Trades*, edited by Sidney Webb.

applied. These conditions existed even before the Industrial Revolution, but, for the most part, have been attributed by economic historians to famines, outbreaks of the plague, wars, civil disorders, irregularities of public finance, or high-handed acts of government. In other words, prior to the industrial era, non-economic factors may have played the most important part in producing fluctuations of this nature. In the absence of reliable statistics it is impossible to submit this view to any searching test. It cannot be doubted, however, that alternating periods of good and bad harvests exerted an influence of considerable importance in an agricultural community.

Since the time of the Napoleonic Wars, the recurring periods of boom and depression appear to have become more frequent and more regular. The influence of harvest conditions would appear to have grown less with the increase in the relative importance of manufacturing industries. Indeed, from such evidence as exists, it seems that the trade cycle as we know it is primarily a phenomenon of large-scale enterprise, and that industries which are characterized by small-scale organization, such as farming, suffer less from the trade cycle than large-scale business such as manufacturing, railways, or mining.

In passing, we may note yet another type of fluctuation which occurs over long periods of time. During a period of, say, twenty years, there may be a general tendency for the average production of a large number of commodities to increase. In such circumstances the general *secular* trend would be upwards. Yet, detailed examination of statistics relating to different industries would reveal tendencies differing considerably from the general trend. Thus, although production in general has increased, the production of some commodities may have fallen. Again, in the course of the same period a number of marked cyclical fluctuations may have occurred. The causes of these secular trends have been classified by Dr. Mitchell under the following headings—

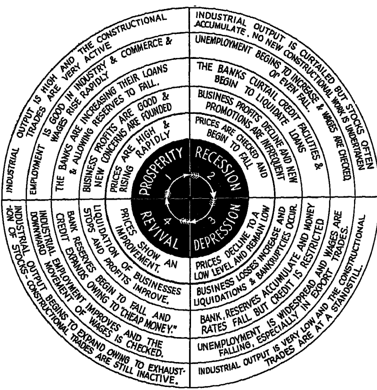
1. Causes related to changes in the number of the population.

2. Causes related to the economic efficiency of the population—its age, constitution, health, education, technical knowledge and equipment, methods of co-operation, methods of settling conflicts of interest, and many other matters.

3. Causes related to the quantity and quality of the natural resources exploited by the population. These causes are, in themselves, extremely complex, and, broadly speaking, we may say that the secular trend is an indication of social progress or retrogression.

NATURE OF THE TRADE CYCLE. Although it is true to say that no two examples of the trade cycle are identical in their characteristics, yet all possess certain resemblances which are fundamentally more important than the differences. It will, therefore, be desirable at this point to outline the salient features of the cycle. In an unending movement of this description, it is impossible to find any point which may logically be described as the beginning or the end of the cycle. Each phase may be regarded as the outcome of that which preceded it. It is possible to distinguish a number of distinct phases of the cyclical movement, even though these blend one into the other. These have been named in various ways, but, following Dr. Mitchell, we may call them in the order of their occurrence, Revival, Prosperity, Recession, and Depression. Since we must select an arbitrary point for commencing our examination, let us take the period of revival.

At such a time, the business world is emerging from a period of depression and bad trade. The precise reasons why depression should be succeeded in this way by revival are complex in the extreme, and, in all probability, are partly physical and partly psychological. A good harvest, a new invention, or the power to exploit new natural resources, may prove the turning point, but, as a general rule, it is a difficult matter to ascribe revival to any single cause. Certain features, however, are present, tending to facilitate revival once the primary impulse has been given. The financial entanglements and over-capitalization which become strongly evident during a depression, have been overcome; bad debts have been written off and inflated capital written down. Many of the more inefficient firms have been eliminated, either by liquidation or through absorption by their more successful competitors. Industrial waste of all kinds, which is apt to pass unnoticed during a period of prosperity, has, by this time, been reduced. The same process of economy has also reduced the overhead charges, whilst wage rates have fallen to a relatively low level.



The above diagram illustrates four characteristic phases of the Trade Cycle, giving certain typical features of each In practice, these phases are by no means of equal duration, nor are they sharply divided the one from the other. Each phase merges into the succeeding one.

At the same time, the competition for employment has caused an improvement in shop discipline and advanced the general efficiency of labour.

From the standpoint of finance, floating capital is plentiful, and, as many of the directions in which it usually finds employment are closed, bank deposits tend to accumulate and rates of interest to fall. The excessive stocks of commodities which, in time of depression, choke the channels of distribution, have been gradually cleared away, and, as they have not been augmented by further production, there may arise a threat of shortage which stimulates productive activity. Consumers who have been obliged to reduce their standard of living during the slump, in the long run are obliged to replace such articles as clothes or furniture. This tendency causes a certain stimulation of trade. Thus, industry as a whole is placed upon a competitive basis, whilst the demand of consumers shows signs of revival. At the outset, however, competition for orders remains keen and there is no appreciable rise in prices, but the larger volume of production enable firms to spread their overhead charges and to reduce the cost per unit of output. More important than this, the revival creates a spirit of confidence, which, in itself, serves to stimulate business. Plant which has hitherto been employed at less than its full capacity now becomes fully active to cope with the increasing demand, and may even prove inadequate to do so. At the same time, rising prices, taken in conjunction with a tendency to lower costs of production, will create an attractive level of profits in certain trades. New capital will be attracted to the industry, both in extension of existing businesses and also in the creation of new competing units. Hence, as an accompanying phenomenon, we find an extension of activity in the constructional trades which deal mainly with the provision of capital equipment.

It must not be inferred from this statement that these tendencies are uniform over the whole industrial field. It is inevitable that they should affect certain trades to a greater extent than others, and leave some quite unchanged. Trades which have entered upon a permanent decline in importance will be but little affected; whilst certain branches of activity will be found to flourish in the midst of deep depression elsewhere. Indeed, the uneven incidence of economic fluctuations in the different parts of the industrial field

constitutes one of the worst effects of the trade cycle. As Professor Pigou points out in an essay—

> The trade cycle, as we know it, involves, not merely an *absolute* oscillation in the demand for labour in all industries collectively, but also a *relative* oscillation as between different industries Thus, in periods of depression, the contraction of demand is much larger in the engineering, shipbuilding, and other constructive industries, than it is in industries devoted to the manufacture of consumable goods This fact, coupled with the fact that workpeople cannot move freely from one occupation to another, causes reserves, or pools of labour, to accumulate round the fluctuating occupations sufficient to meet their needs in good time and, therefore, more than sufficient to meet them in bad times [1]

In consequence, we find a permanent maldistribution of labour, constituting a very grave social evil.

The cycle now enters upon the " boom " period proper. Prices continue to rise and buyers, in anticipation of further rises, precipitate them by purchasing freely and by placing contracts which are beyond their real needs. The productive capacity of industry approaches its limits, and deliveries become increasingly difficult to guarantee. Prices are rising, but, at this stage, costs of production tend to rise even more rapidly. In the first place, the prices of raw materials show a more than proportionate increase, whilst the rise in the cost of living leads to increasing pressure from labour for higher wages At the same time, remunerative prices cause obsolete plant to be kept in operation on an uneconomic basis, whilst the constructional costs of new plant are heavy, and capital so invested bears high rates of interest. Thus, costs of production rise sharply, whether we consider materials, labour, or overhead charges. But these increased costs are becoming very much more difficult to cover by raising prices to consumers. Production is showing visible signs of outstripping demand, and, in so doing, is depressing prices. Manufacturers, instead of undertaking further extensions, try to consolidate their positions, with the result that activity in the constructional trades experiences a setback. The marketing of goods being carried on largely on the basis of borrowed capital, becomes increasingly difficult, as rising interest rates increase the price of such accommodation. Dealers with large stocks on their hands try to unload them, so that prices show a tendency to fall.

[1] Contributed to *Is Unemployment Inevitable ?*

The business world now becomes a prey to uncertainty. Ventures which have been undertaken with a prospect of good returns meet with less success than anticipated, and apprehension follows swiftly. At this stage, certain enterprises rashly conceived in a period of booming trade, are compelled to suspend operations and go into liquidation. The business community as a whole seeks to consolidate its position by the liquidation of stocks and the accumulation of cash This causes prices to drop sharply, both by increasing the quantity of goods seeking a market and also by curtailing the money available as purchasing power. The fact that this course of action is being followed in the merchanting section of the business world has repercussions in the industrial sphere. Manufacturers slow down their operations or suspend work altogether, so that, in consequence, the volume of unemployment increases. Falling prices, which are one of the characteristics of this stage, still further cripple business activity, as we have shown elsewhere, by increasing the burden of fixed charges. Of the items of cost which an industrial producer has to face, that of raw materials usually will have shown the greatest decline, but even this advantage may be offset by the fact that a manufacturer has entered into forward contracts for his materials, and, until these expire, he can reap no benefit.

The other item which figures largely in the expenses of production—labour cost—will also be adjusted during this phase, although with greater difficulty than in the case of raw materials. The fall in prices will lead to pressure from employers to enforce lower rates of wages, and this will be resisted by the workers, who consider that their standard of living is being threatened. Adjustment of wage levels will occur more slowly on account of the fact that the " cost of living," as measured in terms of retail prices, falls more slowly than the level of wholesale prices. Further, as we have already noted in our discussion of wages problems, the whole process of adjustment may be rendered more difficult by Government interference by schemes of unemployment insurance. In this connection, however, it is dangerous to draw hasty conclusions as to the benefits which may be derived from wage reductions—

It is impossible to calculate in advance what increase of employment could be expected from a given average reduction of wages. But the relation of the one to the other might disappoint the expectations of

many people, inasmuch as a false analogy is often drawn from the obvious great advantages to an individual employer of a reduction of the wages which he has to pay. For each employer perceives quite clearly the advantages he would gain if the wages which he himself pays were to be reduced, but not so clearly the disadvantages he would suffer if the money incomes of his customers are reduced. Just as it is to the advantage of each producer that every produce should be cheap except his own, similarly it is to his advantage that all costs and wages should be high except those which he himself incurs—since the demand from his product comes from the incomes which are paid out as costs by other producers.[1]

THEORIES OF THE TRADE CYCLE. On account of the complex nature of the phenomena connected with the trade cycle, there have been put forward a large number of theories to account for them. So far as modern writers are concerned, the question at stake is mainly one of emphasis—to which of the numerous factors involved in cyclical fluctuations are we to ascribe prime importance? Amongst the chief explanations, we may note the following—

1. Physical Theories. Under this heading we have to consider such causes as variations in the yield of crops, discoveries of new mineral deposits, inventions, and improvements. Probably one of the best-known theories falling under this heading is the "sun spot" theory of Professor W. Stanley Jevons, who sought to prove that, as variations in solar energy play an appreciable part in causing variations in harvest yield, they would indirectly affect every field of economic production and give rise to cyclical fluctuations. This theory is now generally discredited, owing to the failure of the sun spot cycle to coincide with the trade cycle. Nevertheless, the importance of crop variations has received attention from such writers as Professor H. L. Moore. A large harvest results usually in a fall of prices of agricultural produce, and so sets free purchasing power for the buyers of such products, which will result in changes of consumer demand.

Taking another point of view, Schumpeter stresses the importance of new discoveries and inventions, the development of new forms of industrial and commercial organization, and the exploitation of new resources. Business enterprise has to adapt itself to the new conditions, but during this period of readjustment, progress slows down and we have a period of depression. When the adjustment

[1] Addendum I, Report of the Committee on Finance and Industry.

has been made and a new equilibrium has been reached, the economic process functions smoothly once more and prosperity returns.

2. Psychological Theories. Under the complex organization of modern industry, the interval between the initiation of production and final consumption is often so great that business men are obliged to plan their activities, not on existing conditions, but on estimates as to the conditions which will prevail at the time when the goods will be ready for delivery. This circumstance gives rise to an opportunity for the intervention of psychological influences which, in the words of Professor Pigou, " consist in variations in the tone of mind of persons whose action controls industry, emerging in errors of undue optimism or undue pessimism in their business forecasts." These psychological factors may be induced in a number of ways—by good harvests, new inventions, or by the conclusion of a successful piece of business—but usually they may be sought in the complex interplay of a large number of events. The important factor is this: that confidence and mistrust are contagious, so that a small movement may rapidly assume large dimensions as a result of the psychological influence which men have upon their fellows.

A change in tone of one section of the business world communicates itself in an irrational manner to other sections of the business community. An error of over-optimism, therefore, spreads and may give rise to economic activity in quarters far removed from its source. Such miscalculations tend to become increasingly frequent as a trade boom approaches its climax, and, when the optimistic expectations of business men fail to be realized, a crisis occurs and with it a psychological reaction. Optimism is displaced by extreme pessimism—the business outlook appears much blacker than it actually is, so that depression settles heavily upon the economic world.

3. Monetary Theories. In the view of those who adopt this explanation of the trade cycle, existing banking institutions and practices cause an inherent tendency towards fluctuations. Upward and downward movements of productive activity are always accompanied by upward and downward movements of prices. The expansion of industry is conditioned by the facilities available for obtaining bank credit. During a trade depression we find large cash balances in the hands of the banks which no one has sufficient confidence to

employ in production. This over-accumulation of bank reserves induces bankers to lower the rates at which they are prepared to lend. Borrowing is thus encouraged and, under the stimulus of easier credit conditions, production expands. As the upward movement continues, there are more and more insistent demands for bank credit in order to meet the increasing expenses incurred in production. Sooner or later the movement leads to an undue fall in the level of bank reserves, and the banks are compelled to raise their interest rates, and so check the expansion of credit. Usually, however, the movement has been allowed to go too far, so that a severe contraction of credit is necessary, and this turns the tide of business from a boom to a recession, culminating in depression.

REMEDIES FOR THE TRADE CYCLE. Although the number of trade cycle theories is legion, it is common ground amongst economists that one of the root causes is the uncertainty of economic life and the lack of knowledge, not only of events in the future, but of current tendencies. Hence, one of the first steps towards a solution of the problem is an improvement of the available data upon which any intelligent appreciation of the economic situation and tendencies must be based. In this connection it has been suggested that the following information is essential—

1. The course of prices.
2. The volume of production of important commodities.
3. Stocks of leading commodities.
4. Quantity as well as value of foreign trade.
5. The consumption of material, to be gauged partly by a study of the preceding three series of figures.
6. The consumption of finished goods, including figures of the turnover of retail trade.
7. Up-to-date analysed information as to railway traffic.
8. Unemployment statistics in detail
9. Wage movements.
10. The quantity of legal tender money in circulation, whether metallic or paper, and the situation as to gold reserves.
11. Quantity and rapidity of circulation of bank money.
12. Shipping statistics, including freight rates.[1]

Statistics, of course, do not provide a solution, but by their aid competent observers can assess the economic situation at something approaching its true value. Economic policies cannot be wisely decided unless future economic probabilities are carefully analysed,

[1] *Is Unemployment Inevitable?*

and such analysis is impossible without adequate statistics of existing conditions. The greater the amount of reliable data available, in respect of current conditions, the more accurate will be the forecasts as to the future, and the greater the number of people who act in accordance with that information, the steadier will be the course of economic life.

The nature of the remedy which it is proposed to apply will obviously vary with the diagnosis of the cause of the trouble. The psychological errors of optimism and pessimism arising, as they do, from the imperfections of human knowledge, are less liable to occur when more comprehensive and accurate economic information is available. If monetary control is needed, then such information once more affords valuable guidance, although it still remains to solve the problem of *when* the banks should exert their influence to increase or to check credit expansion. Those influences which we have termed "physical" causes of the trade cycle are probably the most difficult to deal with. The yield of crops, for example, can be controlled only in a very rough-and-ready manner. We can limit the acreage which is brought under cultivation, but the yield from that area is a much more uncertain matter Scientific forecasts of crops, combined with "organized" marketing, may ultimately provide a solution, but at the present day crop forecasts are often distressingly removed from reality, whilst organized marketing schemes have a history which is far from happy.

The influence of new inventions and changes of consumer demand present even greater difficulties, and are almost certain to cause some temporary dislocation, whilst the economic organism is adjusting itself to the new conditions. In the immediate future, at all events, the most that can be hoped is that such disturbances will be reduced to a minimum, even though it is impossible to eliminate their full effects.

TEST PAPER 13

1. Explain how the complexity of modern economic organization gives rise to the Trade Cycle.
2. Distinguish between Seasonal and Cyclical movements in trade, and show the importance of the distinction when dealing with the problem of unemployment.

3. Is there, in your opinion, much waste of effort and resources in our society at the present time? Discuss causes and remedies as fully as you can.
4. Examine the view that large-scale production leads to a periodic over-estimation of demand which is the direct cause of the trade cycle.
5. What is meant by saying of a particular industry, for example, agriculture or shipbuilding, that it is depressed, and what kinds of causes may bring about such a condition?
6. What do you think should be understood by commercial "crises"? State briefly the causes of such crises.
7. "The Credit Cycle seems to be the effect of monetary conditions upon human psychology" How far do you consider this to be an adequate explanation of economic fluctuations?
8. The world is said to have suffered from general trade depression during 1930. Explain the meaning of this statement, and also the causes that give rise to trade depressions from time to time.
9. "A study of past disturbances leads to the conviction that no serious depression has occurred which was not preceded by loud warnings." What is the nature of these warnings of economic depression, and what action would you suggest should be taken when they are observed?
10. Write a short account of the principal theories which have been advanced in explanation of the trade cycle.
11. "Unemployment is the suitable measure of the trade cycle, and the chief reason for controlling it." Discuss this statement

CHAPTER XIV

ELEMENTS OF PUBLIC FINANCE

HITHERTO we have been dealing with the financial activities of individuals or groups of individuals, and have considered those of the State only in so far as they react upon private enterprise. Thus, in dealing with the money market, we saw how Government operations in Treasury bills have modified its functioning in modern times. We have now to examine more closely the nature of the financial operations of the State—the manner in which it raises its income and how it spends it—since these questions have now come to occupy a vital part in modern economic life. In Great Britain, for example, where the Budget expenditure exceeds £700,000,000, of which more than one-third is attributable to interest on debt, the importance of the subject of public finance needs no emphasis.

We may consider the State as an institution which has developed on account of the necessity for collective action in the satisfaction of certain human wants. It consequently has certain elements in common with other economic units constituted for a similar purpose, though in more restricted fields of activity, such as the family, churches, clubs, and other associations It resembles in many respects the private household, although it preserves its peculiar character by reason of the fact that its field of activity is far wider than that of the household, and it has control of resources which are not accessible to the private individual. Whilst, in the household of the individual, the acquisition of revenue determines the scale of expenditure, in the case of the State, the magnitude of the expenditure will largely determine the revenue. Again, the perpetual nature of the State as an economic unit throws a heavy burden of responsibility upon those entrusted with the administration of the public finances, for they must adopt a course which will not only satisfy current requirements, but which will also not impose an unfair burden upon future generations. It is to be feared that modern finance ministers have paid far too little attention to this aspect of their duties. They have looked to the immediate need of

the moment, and have been inclined to let the future take care of itself. The private individual or the business undertaking cannot afford to do this—

An individual company usually borrows with a careful consideration of the consequences, which must fall directly on those who direct it The lender is also more cautious because his security depends on the limited and calculable resources and prospects of the borrower Moreover, if the transaction proves a bad one, the consequences are restricted both in range and in time The individual dies and no heir is legally saddled with a net liability; the company goes bankrupt, and its insolvency does not destroy the credit of others

But when the borrower is a Government, default affects the credit of the whole nation and every individual concern in it. Moreover, there are the dangers of both a short and a long expectation of life. Too often the contracting minister thinks largely in terms of his probable tenure of office, which is usually short, rather than that of the loan. But if political life is shorter than personal life, the nation which bears the burden is immortal, and the charges of a rashly-negotiated loan may extend over generations [1]

The problems of public finance have assumed greater importance than ever during recent years. The Revolutionary and Napoleonic Wars of the early nineteenth century strained the public finances of that period to an incredible extent, but the difficulties of those days were nothing in comparison with the effects of the World War, for where thousands of pounds were spent in the first case, millions were spent in the second. Both victors and vanquished have had to find an entirely new basis upon which to build, and greater sacrifices have been demanded of individuals.

EXPENDITURE OF THE STATE. The modern development of State expenditure continues to depend upon the extension of governmental activity. In all countries, even before the War, there was a gradual growth in the scale of public expenditure. The greatest increase in this expenditure took place in regard to the sums spent upon armaments, both on land and on sea. This growth in the magnitude of public expenditure attracted attention to this important side of public finance which most writers on the subject had previously neglected. So long as public opinion held that the principal duty of government was the maintenance of law and order at home and the defence of the community from external aggression, then State expenditure was pushed down to an irreducible minimum.

[1] Sir Arthur Salter, *Recovery*.

The view that national expenditure ought to increase in proportion to the spread of wealth was one that received but scant sympathy from orthodox Victorian finance. But the changing current of economic and social life brings new views on the functions of government. The modern State has to provide large sums annually for the education of its citizens, for social insurance of one kind and another, and for direct and indirect assistance to industry and trade. In view of these ever-increasing and competing demands upon the public purse, a scientific examination of public expenditure has become an urgent necessity. When Gladstone said that "good finance consists more in the spending than in the collecting of revenue," he enunciated a truth which has too often been forgotten or ignored by modern statesmen with disastrous results.

Writers on public finance have adopted a variety of methods of classification in dealing with the various items of public expenditure. A summary of these methods of classification is given in the table on page 334. The methods which found most favour in the eyes of nineteenth century writers were those which considered the benefit conferred or the revenue received in return for the services rendered. If we examine public expenditure from the standpoint of the benefit received, it should be remembered that it is the duty of government to act on behalf of the community as a whole Hence, the primary objective of public expenditure should be the general benefit and not merely that of sectional interests. Yet, the mere fact that a given expenditure will result in a general benefit to the members of a community is not in itself a sufficient justification, but consideration must also be given to the necessity for the expenditure, as well as the existing burden of taxation and the economic condition of the country. In the case of expenditure which confers a general benefit, it is not usually practicable to levy a specific charge for the service rendered. We cannot assess the benefit which an individual derives from the British Navy or the Police Force, so that the revenue for such services must be obtained by some means other than a specific charge upon those enjoying the benefit. In the case of special benefits however, it may be possible to levy a charge upon the recipients in proportion to the service rendered. This brings us to the second method of classification—according to the amount of revenue obtained by the State. In this case we have services ranging from

METHODS OF CLASSIFICATION OF PUBLIC EXPENDITURE

Classification According to Benefit Received	Classification According to Revenue Received	Classification According to the Functions of Government	
(1) Those items of expenditure which confer a common benefit on all citizens. E.g., defence, public health services.	(1) Expenditure without any direct return by way of revenue. E g. poor relief, pensions.	(1) Protective Functions— (a) Military. (b) Police and Court. (c) Social Diseases (prisons, asylums, pauperism, sanitation, etc.).	(1) Primary Expenditure— (a) Defence. (b) Law and order (c) Civil administration. (d) Debt services.
(2) Those which confer special benefit on certain classes, but which should be treated as a common benefit because of the incapacity of these classes. E.g. poor relief.	(2) Expenditure without direct return, but with indirect benefit to the revenue. E.g education, it being supposed that the educated are better taxpayers.	(2) Commercial Functions— (a) Fiscal monopolies. (b) Postal system. (c) *State railways and shipping.*	(2) Secondary Expenditure— (a) Social. E.g. Education. Public health *Poor relief.* (b) Public Undertakings. E.g. Railways. Irrigation Canals. Roads. Post offices. Waterworks. (c) Miscellaneous. E.g. Pension charges Drawbacks.
(3) Those which confer *both* a special benefit on certain persons and a common benefit on all the others. E.g. administration of justice.	(3) Expenditure with partially direct return. *E.g. education for which* fees are received, or subsidized railways which meet part of the expense.	(3) Developmental Functions— (a) Education. (b) Public recreation. (c) Prosecution of private business. (d) Public investigation. E.g. collection of social statistics. (e) *The development of the physical basis of the State. E.g. public works, docks, etc*	
(4) Those which confer only a special benefit on individuals *E.g. State* industries, subsidies, etc.	(4) Expenditure that obtains a full return, or, in extreme cases, yields a profit in addition, for example, the Post Office, gasworks, and State industries generally.		

those yielding no return, such as poor relief, to those which are "self-balancing," such as the Post Office.

A further classification may be based upon the nature of the functions undertaken by the Government. Thus, Professor H. C. Adams classifies expenditure under three general types of functions of public services, namely, protective, commercial, and developmental. The difficulty in adopting this classification lies in the overlapping of functions which is inherent in the public service, making it difficult to determine the proper head to which the various expenses are to be assigned Items which one person would describe as protective outlay, another would designate developmental. The statistical information collected by the Board of Trade might sometimes be called commercial, and at others, developmental A more satisfactory division, on the same lines, is that adopted by Professor Shirras, who divides public expenditure into two classes based upon the primary and secondary expenditure of Governments. The primary expenditure covers those disbursements in respect of essential services—those functions which every Government must perform if it is to merit recognition as such. Secondary functions include everything over and above this irreducible minimum, such as social services and Government industries. The composition of these latter changes with the passage of time, and is never the same in any two countries at a given moment. The magnitude and scope of these secondary functions will vary with the state of public opinion, the degree of prosperity, and the stage of economic development.

ORDINARY AND EXTRAORDINARY EXPENDITURE. Government expenditure may again be considered under two headings—ordinary and extraordinary expenditure. Although these two terms are self-explanatory, there arise, in practice, considerable difficulties in assigning given items of expenditure to the appropriate class The ordinary expenditure covers the regular items accruing in every financial period, the total of which remains steady or is subject to a known rate of change. Under the same heading, too, are included provisions for such expenditure as the construction and repair of public buildings, which occurs only occasionally, but which can be predicted with reasonable certainty from past experience. Extraordinary expenditure, on the other hand, is that which occurs as a

result of some particular emergency or unexpected event, so that it cannot be allowed for with any approach of accuracy. The most frequent type of extraordinary expenditure is that incurred in time of war. Yet, as Bastable pointed out, the distinction is a vague one and tends to pass away as national budgets grow larger and financial estimates more accurate—

> When the outlay is measured by thousands a variation in hundreds is serious, but when it reaches millions, changes of thousands are trifling, besides being balanced through savings in some other parts of expenditure. There is also in modern states a greater facility for foreseeing, and, so to say, "discounting" the future. The refined financial mechanism by which public borrowing is carried out enables "extraordinary" expenditure for a short period to be transformed into "ordinary" expenditure for a long one [1]

This distinction between ordinary and extraordinary expenditure assumes the greatest importance when we are faced with the problem of arriving at a decision as to how it shall be met. It is usually held that the former should be met from current receipts, that is, from taxation and other current resources, whereas the latter should be met by the use of public credit or some similar device. Thus, the Brussels Financial Conference of 1920, in indicating the lines of post-war financial reconstruction, said, "Every Government should, as the first social and financial reform on which all others depend, restrict its ordinary recurrent expenditure, including the service of the debt, to such an amount as can be covered by its ordinary revenue; abandon all unproductive extraordinary expenditure; restrict even productive extraordinary expenditure to the lowest amount. If the above principles are accepted and applied, loans will not be required for recurrent ordinary expenditure; borrowing for that purpose must cease."

Here the principle which is to be followed is made quite clear—ordinary expenditure must be reduced to such limits that it can be covered by current revenue, and only unavoidable extraordinary expenditure be met out of loans. The great difficulty again arises in assigning given items of expenditure to one or other of these classes. In dealing with the whole question it is fairly evident that practical expediency will always play a large part. After the burden of taxation has reached a certain level, the Government will often

[1] *Public Finance*

tend to resort to borrowing if a loan can possibly be floated. We may reduce the number of cases where extraordinary expenditure can be met by borrowing to three, namely—

1. Emergency Finance. It is permissible to use loans in financing an emergency, the cost of which is so great that taxation alone will not suffice. Of such emergencies, war is the chief, and is the most difficult to finance, since its duration, cost, and extent are uncertain. Modern warfare makes tremendous demands upon the resources of a nation, and the scale of expenditure is such that it cannot be supported by taxation alone. In justifying borrowing for this purpose, McCulloch goes so far as to say, "No sacrifices can be too great that are required to preserve national security and independence, and a loan expended on armies and fleets employed for such a purpose is quite as well and profitably employed as if it had been laid out on agriculture or in promoting manufactures or trade." This statement is so extreme that it defeats its own purpose, but nevertheless in times of war the fate of future generations is equally at stake, so that on this ground it is only fair that they should bear some part of the burden.

In adopting this attitude we have next to determine what proportion of the expenditure shall be passed on to future generations—in other words, what proportion shall be financed by loans and how much by current taxation. Usually it will be found that, upon the outbreak of war, funds must be borrowed in order to cope with the immediate jump in expenditure. Later, as the machinery of taxation can be speeded up, expenditure out of revenue should increase to cover both interest charges and also as high a proportion of current expenditure as possible. Experience during the Great War illustrates the differences of policy. In Germany it was believed that a short, intensive campaign would bring victory, so that the cost of the War could be defrayed by internal loans which could subsequently be repaid by indemnities levied upon the vanquished. As a result, over 90 per cent of the War expenses were raised by loans. On the other hand, in England, taxation increases supplied eventually something like one-quarter of the total war expenses. It is argued in favour of high taxation to meet the cost of war that such a policy will result in more economical expenditure, and will check extravagant and unnecessary consumption. Again, reliance on

taxation would avoid some of the inflation and high prices which loans almost inevitably produce when undertaken on a large scale. A policy of taxation, in addition, lightens the post-war problem of debt payment, and avoids the long period of heavy taxation to meet the debt charges.

We may include under this heading the extraordinary expenditure which is necessitated in the work of post-war reconstruction in devastated areas, where reconstruction charges cannot possibly be met from ordinary receipts. The restoration of such regions is of primary importance for the re-establishment of normal economic conditions, so that loans for this purpose have every justification.

2. Permanent Productive Enterprises. A State may borrow money in order to meet the capital expenditure involved in the construction of productive undertakings, such as railways, irrigation works, and electricity undertakings. The same is true of some expenditure which might be classed as "non-productive" in the sense that it yields no direct revenue, though it adds to the efficiency and ultimately to the wealth of the community, such as roads or public buildings. In the case of public undertakings of these types, it is obviously unfair to ask the taxpayers during a single year to bear the entire burden, when the benefits are going to be received over a long period of years. On the other hand, of course, in the case of commercial enterprises undertaken by the Government, it is necessary to justify Government participation. An industry may sometimes be publicly owned and managed because it is necessary in the interests of the public, but private enterprise is incapable of providing the required capital, or is unwilling to assume the risks involved. Thus, in many countries, the State ownership of railways was occasioned by these factors. When, however, we enter the field of activity which is, or has been left to private enterprise, then we find ourselves in a sphere of bitter controversy. To what extent is the State justified in entering into competition with its own citizens, or of taking over by compulsion their businesses and operating them itself? We can only reply in general terms and say that public interest may warrant such a course, and that each case must be taken on its own merits.

The fact is that the suitability of an enterprise for State control varies greatly according to its character. Where its development has already

resulted in a practical monopoly, so that the public get the benefit neither of competitive prices nor of controlled profits, where such competition as remains takes the form of attracting the consumer by advertisement, costly shops, appeals of agents on commission, and not of reduction of price or improvement of quality, and where hazardous experiment is not greatly needed; there is a *prima facie* case for the State. The case is proportionately weaker as far as these conditions do not apply.[1]

In order that the expenditure of public money may be justified there must be strong reasons for the interposition of the State in industrial enterprises. The State should be in a position to operate them at least as efficiently as the private entrepreneur, and secure a greater freedom from any abuses to which they may have been subjected—and in these respects the past history of State-owned enterprises is none too reassuring. The taxpayer may ultimately be called upon to make good a deficit on the operation of public enterprises, and where this occurs it should be possible to point to some compensating advantage Where a case can be established for State enterprises, then there is considerable justification for providing the original capital expenditure from borrowed funds.

3. Temporary Deficit. In case of necessity, in order to cover a temporary deficit, recourse may be had to borrowing. In the modern State, with its tremendous expenditure, it is quite impossible always to forecast accurately the amount that will be required during a fiscal period, or to gauge the yield of the many sources of revenue. The only way in which to ensure that revenue would always exceed expenditure would be to budget for a fairly large surplus, and this, apart from the resentment which it would be likely to arouse in the taxpayer, is apt to encourage extravagance. The employment of borrowing for this purpose is a power which cannot be used with too much caution. To meet a series of deficits by borrowing money to bridge the gap is simply to court disaster sooner or later. Borrowing may be permissible to meet an occasional deficit, but if the shortage becomes habitual, then more revenue must be obtained.

An example of the dangers of borrowing in this way is furnished by the recent working of the Unemployment Fund. Up to September, 1931, a large part of current expenditure on unemployment

[1] Sir Arthur Salter, *op. cit.*

benefit was treated not as a charge on current revenue, but as a loan to be repaid out of the receipts of the Fund. The Unemployment Fund had been insolvent since July, 1921, and by September, 1931, the total indebtedness exceeded £104,000,000, and was increasing at the rate of £1,000,000 a week. As the Royal Commission on Unemployment Insurance pointed out, "Borrowing on behalf and on the security of the Fund is not, in principle, objectionable, if the purpose of the borrowing be to meet a temporary emergency, under circumstances which disclose a reasonable promise of early liquidation of the debt. But it is quite clear that recent borrowing has not been of this character. It has been on a scale far exceeding the probable capacity of the Fund to repay, and the debt is now increasing annually at a rate which equals the annual income of the Fund." It was admitted that under existing conditions of unemployment, the Fund could not be expected to balance without assistance, but continued State borrowing on such a scale would soon have undermined the stability of the British financial system. The Treasury loans represented State borrowing to meet current obligations at the expense of the future. This drift was stopped after the Emergency Budget of September, 1931, and now the Budget carries every penny of the cost of unemployment benefits which is in excess of the capacity or the proper functions of the Unemployment Insurance Fund itself.

CANONS OF EXPENDITURE. In so far as the Government is employing resources which have been contributed mainly by the citizens through taxation, it will be evident that State expenditure should be governed by rigid principles. One writer[1] has recently propounded three tests, to be applied to every form of public activity, whether national or municipal. "First: Is the work worth doing? Is the need for it real? Second: Is there no other way of achieving the same object, no cheaper or more efficient or more reliable agency through which it can be secured? Third: Have we the money to pay for it?" The third test is, of course, decisive, since no matter how desirable certain expenditure may be, if the community cannot afford to pay for it they must go without. Where expenditure is undertaken, the following principles should be observed.

[1] Sir Ernest Benn, *Honest Doubt.*

1. Canon of Benefit. The expenditure of the State should be so directed as to confer increased social advantages upon the community as a whole. Indeed, it has been said that the State should expand its expenditure so long as there is a greater social gain to be derived from the public use of the money that is spent than would have been derived from the private use to which this money would otherwise have been devoted. This version of the principle may be unobjectionable in theory, but its realization is out of the question in practice. The public revenues are unfortunately not invariably derived from those resources which are employed in the least productive manner in the hands of private individuals.

Another factor which must be kept in mind is the distribution of expenditure. The balance should be held fairly between one object and another, so that one sphere of public activity is prevented from developing at the expense of another.

The ideal of public expenditure on the utilitarian principle would be attained when the public utility of the marginal expenditure in each case is equal. The idea is no doubt unattainable, but it is not unthinkable, and the pursuit of it may lead to important practical results Without a beacon of this kind expenditure may be continued in certain directions long after it is justified by changing conditions, and the most necessary reforms may be met with the *non possumus* of passive inertia.[1]

2. Canon of Economy. The second principle which must be observed is that, in handling public money, at least as much care should be exercised as in spending private income. A scrupulous adherence to this principle is essential if the level of taxation is to be kept at the lowest limit, and in any case, no matter what the burden of taxation may be, the wasting of public funds can never be justified. The Committee on National Expenditure, which reported in July, 1931, gives a number of instances in which sufficient care has not been exercised in the disbursement of public funds. The Unemployment Grants Committee, for example, was appointed to make grants towards works of public utility carried out by local authorities, other than road and housing schemes. The Committee on National Expenditure came to the conclusion that after ten years of working this scheme had largely resolved itself into giving grants to local authorities and others to carry out their normal responsibilities. After reviewing the nature of the grants, they put forward the

[1] Nicholson, *Principles of Political Economy*

opinion that much of the expenditure had been unwise in that it had been incurred considerably in advance of requirements.

3. Canon of Sanction. This is the principle that no public expenditure should be incurred without proper authority being received. Thus, in Great Britain, no money can be raised by taxation and none can be spent except under the authority of Parliament. Furthermore, no money can be spent save for the purpose to which Parliament has appropriated it. The Treasury is given power to make issues out of the Consolidated Fund into which the proceeds of all taxation are paid. The Treasury, in its turn, must satisfy the Comptroller and Auditor-General that the requisition is in accordance with the Acts which govern the proposed expenditure.

4. Canon of Surplus. Governments, in the same way as private individuals, should endeavour by every means within their power to keep expenditure within the limits set by current revenue. In other word, financiers should avoid deficits whenever possible. This does not imply, of course, that the accumulation of a large surplus should be the aim and object of public finance for, as already pointed out, this may result in waste. The aim should be to balance revenue and expenditure as closely as possible.

ECONOMIC EFFECTS OF PUBLIC EXPENDITURE. As we have already seen in dealing with the Bank of England and the money market, the financial operations of the Government are capable of exerting a big influence upon financial institutions. But the economic effects of public finance are obviously more far-reaching than this, and affect either directly or indirectly all individuals and institutions within the community. The Government, through its system of taxation and expenditure, is responsible for the transference of large amounts of wealth from one employment to another, and this redistribution is bound to have effects which cannot be ignored. Certain of these consequences are deliberately calculated by the Government; others merely occur as an indirect consequence of some other action.

Thus, State expenditure may be deliberately employed to stimulate certain branches of production, usually by providing bounties or subsidies from public funds. Such expenditure, of course, requires a very strong justification, since it involves the employment of public funds for the benefit of sectional interests and may easily

cause an undesirable competition on the part of other industries for assistance Again, the State may, more legitimately, stimulate industries by making grants for research where private enterprise cannot undertake this unaided.

One of the most important questions of recent times has been the possibility of the Government planning its expenditure in such a way so as to influence industrial activity in general. It has been argued that, inasmuch as modern industrial activity appears to move in cycles of alternate boom and depression, these fluctuations might to some extent be counteracted by the action of the State and local authorities in adjusting their expenditure and concentrating it in those periods when private business was slack. This policy in connection with public works has two aspects, namely, on the one hand, to reserve for periods of unemployment work undertaken for public authorities, and on the other, to organize and create entirely new works in periods of depression in order to stimulate industrial activity. It certainly can be claimed that the total expenditure of the Government is so great that its incidence in time has considerable effect on private industry. The large sums spent annually by public authorities constitute a tremendous demand for goods and services, and the transference of this demand, or a large part of it, from one time to another could not fail to react on employment and industrial activity. So far as the question of postponing public expenditure is concerned, there are certain limits to the operation of the policy, for not all the orders of public authorities can be postponed or advanced. All the regular administrative work must be carried on continuously, and this at once excludes a large proportion of public expenditure from the scope of the proposed policy.

The undertaking of large schemes of capital expenditure by the Government in times of depression has encountered considerable criticism. The Committee on Industry and Trade took the view that "A large part of the public work which is susceptible of postponement or acceleration is work of special kinds, which could not provide employment in their own trades for any considerable number of unemployed persons. Moreover, the experience of the post-war depression, when considerable inducement was held out by the Government year after year to local authorities and others to

expedite necessary work in order to provide immediate employment, shows that in a long-continued depression the possibilities of *bona fide* anticipation become rapidly exhausted." The amount and nature of employment given by Government expenditure of this type have been the subject of widely varying estimates. One of the most serious objections to public works as a relief for unemployment lies in the fact that skilled workmen are likely to be employed on unskilled work, and that often men are transferred to work for which they are not fitted. Yet it is a big mistake to suppose that only those who are directly employed reap any benefit. When public works are instituted, not only is employment given to those immediately concerned, but also to other persons engaged in making materials for the works in question The amount of additional employment thus given is a matter for conjecture, but it is generally thought to be about equal to the direct employment.

A number of other criticisms of this type of Government expenditure were advanced by a witness[1] before the Committee on Finance and Industry. First of all, there is the attitude of the public towards the schemes, and although many people may regard them as sound, others may take the view that they are projects of extravagance and waste. In fact, so far from setting up a cycle of prosperity, there might be a big outcry against bureaucracy. If this were the reaction then, when the Government attempted to float loans to finance the schemes, the response might be poor, and the general despondency of business heightened rather than relieved. Again, even allowing for indirect employment, it would seem that the trade revival would be somewhat one-sided and not permanent.

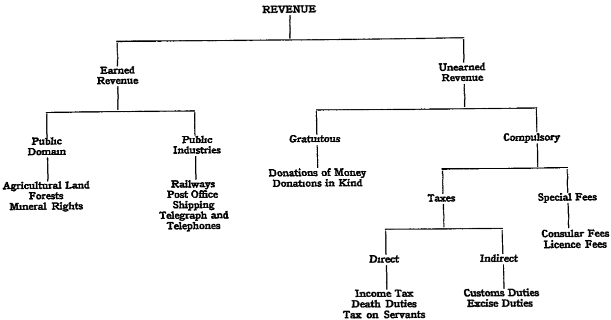
In addition to the foregoing objections, there has also been a great deal of controversy as to whether public works do not merely divert money from private industry to Government purposes without adding in the amount of employment given. In reply to this it is argued that there is generally during a depression an excess of capital that cannot find investment, so that the rate of interest falls. This is, therefore, a particularly favourable moment for raising money for the construction of public works, for not only is it cheaper, but the fact that private industry is unable to make use of it is a very good reason for public authorities to do so.

[1] Sir Richard V. N. Hopkins, *Minutes of Evidence* (Vol. II).

THE REVENUE OF THE STATE. The ordinary revenue of the State may be divided into the earned revenue which arises in a manner similar to that of the private household, and that which is compulsorily obtained in the form of taxation. The earned revenue is that which is obtained from the direct use and operation of its natural resources, or when it engages in industry in a manner similar to private enterprise. Amongst these are included the revenues from the Post Office, State banks, and railways, and from the State ownership of land. In speaking of earned revenue, we may distinguish between the income which is derived from the State ownership of land, and that obtained from public industries. Formerly, the most important part of the revenue of the State was derived from the royal domain. Indeed, the sovereign held his position in part, at least, by virtue of the fact that he had large estates of land which would yield him an income sufficient to meet the expenses of the Royal Household. As the various rulers squandered their landed possessions, revenue from this source declined in importance.

The declining importance of public revenue from the ownership of land has been counterbalanced in many States by an expansion of Government activity in the sphere of industry. The motives which induce the public authority to undertake industrial enterprises are not always connected with the raising of revenue. Thus, the Government may take over certain forms of economic activity which are necessary to the community, but which private enterprise is unwilling or unable to provide. On such grounds many Governments have been compelled to construct and operate railways. Again, the State may acquire and nationalize certain industries in order to prevent the members of the community from being exploited by private monopolists. In other cases certain services may be provided by the State, because it is thought that they can be provided more cheaply and efficiently by this means. Finally, and less frequently, an industry may be taken over and operated with a view to raising the maximum revenue. Thus the French tobacco monopoly has yielded large contributions to the French Treasury, either in the form of taxes or as monopoly profits. Frequently, of course, Government ventures into industry do not yield a surplus for the relief of taxation, but deficits are incurred which have to be made good by the taxpayer.

THE REVENUE OF THE STATE



The unearned revenue of the State is composed of contributions which are imposed upon its subjects without any proportionate counter-service being rendered. Revenue of this type may be derived from two main sources, namely, special fees and taxation. A fee is a charge made for a special service rendered to the individual by some governmental agency. The amount of the fee is supposed to be based upon the cost of the service rendered, or at all events upon the special cost of maintaining the department which performs the work, although in practice many fees are arbitrarily adjusted without regard to the present cost of the service. Yet, though a fee is greater than the actual cost of the service warrants, it may still be differentiated from a tax on the ground that a special benefit is being conferred, and that if a person is prepared to forgo the benefit, he need not pay the fee.

The revenue which is derived from taxation in the modern State transcends in importance that received from other sources. A tax has been defined by Bastable as "a compulsory contribution of the wealth of a person or body of persons for the service of the public powers." The great importance of the subject of taxation arises not only on account of the important share which it contributes to the income of the modern State, but also on account of the problems, theoretical and practical, to which it gives rise. The amount of taxation will be largely dependent upon the expenditure incurred by the Government in the performance of its legitimate functions. Having settled the absolute amount of taxation, the next question is the manner in which the taxes are to be levied. Finally, it will be necessary to form an estimate as to what their ultimate economic effects are likely to be The principles according to which taxation should be raised have already been considered elsewhere,[1] and we shall here content ourselves by stating the four canons of taxation as enunciated by Adam Smith in the *Wealth of Nations*—

(1) **Canon of Equality.** The subjects of every State ought to contribute towards the support of the Government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the State The expense of government to the individuals of a great nation is like the expense of management to the joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests in

[1] *Economics of Production and Exchange* (Pitman), by the same authors.

the estate. In the observance or neglect of this maxim consists what is called the equality or inequality of taxation.

(2) **Canon of Certainty.** The tax which each individual is bound to pay ought to be certain, and not arbitrary The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. Where it is otherwise, every person subject to the tax is put, more or less, in the power of the tax-gatherer, who can either aggravate the tax upon any obnoxious contributor, or extort, by terror of such aggravation, some present or perquisite to himself

(3) **Canon of Convenience.** Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it A tax upon the rent of land or of houses, payable at the same term at which such rents are usually paid, is levied at the time when it is most likely to be convenient for the contributor to pay, or when he is most likely to have wherewithal to pay. Taxes upon such consumable goods as are articles of luxury are all finally paid by the consumer, and generally in a manner that is very convenient for him He pays them by little and little, as he has occasion to buy the goods As he is at liberty, too, either to buy, or not to buy, as he pleases, it must be his own fault if he ever suffers any considerable inconveniency from such taxes.

(4) **Canon of Economy.** Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the State. A tax may either take out or keep out of the pockets of the people a great deal more than it brings into the public treasury in the four following ways. First, the levying of it may require a great number of officers, whose salaries may eat up the greater part of the produce of the tax, and whose perquisites may impose another additional tax upon the people. Secondly, it may obstruct the industry of the people, and discourage them from applying to certain branches of business which might give maintenance and employment to great multitudes Thirdly, by the forfeitures and other penalties which those unfortunate individuals incur who attempt unsuccessfully to evade the tax, it may frequently ruin them, and thereby put an end to the benefit which the community might have received from the employment of their capitals. Fourthly, by subjecting the people to the frequent visits and the odious examination of the tax-gatherers, it may expose them to much unnecessary trouble, vexation, and oppression

TAXABLE CAPACITY OF A COUNTRY. We have now to examine the question as to how much taxation a country can bear, that is, what is the taxable capacity of the nation? There is an old story which asks how many cows' tails would reach the moon, and the answer is one—if it was long enough. The answer to the question as to how much taxation a nation can bear is any amount—provided that the nation is rich enough and the taxes are levied in accordance with the canons of taxation. The concept of taxable capacity is

obviously one of the greatest importance, since it informs us as to the maximum amount of wealth which the citizens of a country can contribute towards the expenses of the State without having to undergo an unbearable strain. We may evaluate the taxable capacity as the difference between the national production and the minimum consumption of commodities and services required to maintain that volume of production, the standard of living remaining unaltered. Now these matters do not readily lend themselves to precise measurement. The national income, which is the money value of the goods produced and the services performed in a community within a given space of time, cannot be measured with any high degree of accuracy on account of the duplication of items and the many services which cannot be valued. On the other hand, the minimum consumption necessary for efficiency presents further difficulties of ascertainment. But assuming that these difficulties could be cleared away, we have still to consider the psychological reaction of the taxpayer to the situation. We may determine the minimum amount of the national income which must be left to the producer in order to leave him in a position to maintain his former volume of production, but we have still to ask ourselves whether he will be willing to continue to put forth the same effort on such terms. As Sir Josiah Stamp says, "taxation is not merely a stationary or a static problem, the cutting up of an existing cake—it is a moving and a dynamic problem. We have to ask not only how little we can leave him with, but also, how much reduction will he stand before he slackens in work and abstinence. How long will he come up smiling to be taxed in this way?"[1]

In the face of a diminution of income due to increased taxation, one person may work harder in order to maintain himself at the former level. In consequence, production may increase by roughly the amount of the tax. On the other hand, his reaction may be a feeling of discouragement—a disposition to give up the unequal struggle, so that business enterprise may be checked and the volume of production curtailed Sir Josiah Stamp enumerates the following factors which have to be taken into consideration in determining the limit of taxable capacity—

1. It depends upon what the taxation is to be used for.
2. It depends upon the spirit and national psychology of the people taxed, which may be influenced by patriotism or sentiment.

[1] *Wealth and Taxable Capacity.*

3. It depends partly on the way the taxation is raised, both as to the methods adopted and the rate at which the increase is laid on

4 It depends on the distribution of wealth.

5 Its rate of increase is greater than the rate of increase in wealth, and it shrinks more rapidly than the wealth diminishes

Taking these factors in order, we may probably assign the greatest importance to the first. If the proceeds of taxation are applied in the payment of internal debt interest, then the taxable capacity would be greater than if the money was applied in the service of foreign debt. In the payment of interest on an internal debt, the goods taken away from the taxpayers in their capacity as producers are returned to them in their capacity as receivers of interest. The mode of distribution may be different, but the national income will suffer, at most, only a small reduction. If, however, the proceeds are applied in the service of a foreign debt, then the sum paid away is a loss to the national income, and leaves the community poorer. Secondly, as we have already seen, the psychological attitude of the people to taxation will react on their productivity, and consequently on taxable capacity. This factor may be modified by appeals to sentiment and patriotism. Thirdly, the manner in which the taxation is imposed will have a considerable influence upon taxable capacity. Taxes which set in defiance the canons of taxation which we have enunciated above are likely to prove much more burdensome than taxes which are very much heavier, but which are fixed in accordance with those principles. Again, the distribution of the national income influences taxable capacity which will not be the same if incomes are more or less equal, as it would if they were graduated. Finally, taxable capacity shrinks more rapidly than national income falls, because there is a minimum which must be retained in the hands of the people for bare subsistence, and, as this point is approached, the yield of taxation falls quickly.

INCIDENCE OF TAXATION. We now pass to another aspect of taxation, namely, its incidence. A tax is said to be incident upon the person who ultimately pays it without the possibility of passing the burden on to any other person. After the original "impact" of a tax, the person who first pays it may contrive by some means or other to put the payment on to someone else. This intermediate process is known as "shifting" the tax. The ultimate result of this process of shifting is known as the incidence of the tax. The

incidence should be clearly distinguished from the question of the further effects of the tax, although these latter may be very important. For example, the burden of a tax may rest upon an employer, and in consequence he may cut down his staff, in this case, the effects of the tax may be more serious to the employees than to anyone else, but the incidence of the tax is not said to be upon them but upon the employer.

The incidence and shifting of taxation was first mentioned by Tacitus, the great historian of the Roman Empire. He points out that at Rome there was imposed a certain licence duty on dealers in slaves. Yet, he says, it was not the dealers in slaves who paid the licence, but the people who bought the slaves. The amount was collected from the slave dealer, but was paid by the man who ultimately bought the slave An early theory considered that all taxes were repercussive, that is, they rebounded from one person to another. Thus, Lord Mansfield, towards the end of the eighteenth century, said, "I hold it to be true that a tax laid in any place is like a pebble falling into and making a circle in a lake, till one circle produces and gives motion to another, and the whole circumference is agitated from the centre." The Physiocrats held the theory that all taxes were shifted so that ultimately they had to be paid out of the produce of the soil. This doctrine was a direct corollary of the doctrine of minimum subsistence. The Physiocrats thought that the labourer existed at a minimum of subsistence, so that they argued that if wages were taxed, the worker could not live on them, so that he would require an increase, thus shifting the tax to the employer. Again, going back farther, the tenant farmer was ground down to the very minimum of profit, so that if he were taxed it would be at the expense of the rent paid to the landlord. Adam Smith considered that taxes might be incident upon any of the three factors of production, so that taxes might be paid from wages, profits, or rent.

Ricardo, in his *Principles of Economics and Taxation*, published in 1817, in dealing with taxation, confined himself almost entirely to the consideration of the incidence of taxes. Ricardo held the view that a tax on rent was not transferable, because rent, being the surplus over the cost of production, a change in the price of the produce cannot be affected by the tax. He considered, however, that a

tax on wages was incident on the employer, but a tax on general profits was not transferable because a man could not avoid that tax by going from one business to another. On the other hand, a tax on the profits of a particular business would be shifted to the consumers of the article made in that business. If there were a tax on profits of shoemakers only, then the tax would be transmitted to the wearers of the shoes, or if not, the producers would go into some other occupation. John Stuart Mill, knowing that wages in England were not at the minimum subsistence level, used the standard of comfort as the determining factor in the incidence of many taxes. For instance, according to Mill, a tax on wages will be incident on the employer if the standard of comfort is rigidly maintained, but it will be a tax on the labourers themselves if they allow their standard of comfort to fall off.

The incidence of a tax may move in various directions: we may have forward, backward, and diffused shifting. A commodity moves from producer to consumer and somewhere between the two stands the tax-gatherer. If the tax is incident upon anyone between the tax-gatherer and the producer, we have a case of backward shifting; if it is incident upon a person between the tax-gatherer and the consumer, then we have forward shifting, whilst if the tax spreads itself through the community in all directions, then we have diffused shifting. The difficulties which have to be overcome by the person bearing the impact of a tax in attempting to shift it are—

1. He has a greater opportunity of recovering the tax if he can change from one occupation to another, that is, if his capital is mobile.

2. If he cannot easily move from one business to another, then he may not be able to obtain payment of the tax A further obstacle to his transfer of the tax is a great elasticity in the demand for the commodity taxed. A demand is said to be elastic when a slight change of the price makes a great change in the amount purchased.

If the tax on coffee is raised, it may not be easy for a dealer to transfer the tax to the consumer because by so doing he will raise the price, and probably curtail the demand. In the case of a commodity, the demand for which is elastic, a sudden increase of the tax will probably fall upon the merchant himself He will not be able to shift the tax to the consumer by an increase in price because if he attempts to do so the demand will fall.

3. If an article is produced under conditions of monopoly, it may be impossible to shift the tax. A monopolist sells his commodity at a price which yields him the maximum net return. If, therefore, he adds the amount of the tax to his selling price, it will be increased to a level which will yield a smaller return In these circumstances, it will be to the interest of the monopolist to pay the tax himself.

4. The manner in which the tax is imposed may also give rise to difficulties. A tax of one shilling on a barrel of beer, collected from the brewers, would be a difficult tax for the brewers to pass on to the consumer, because a barrel contains thirty-six gallons, and they cannot recover the amount of the tax by adding a small amount to each glass of beer sold. If ½d. were to be added to the cost of each glass of beer there would be a great outcry amongst consumers, since the brewer would be recovering far more than the amount of the tax. The tendency is for the brewer to recoup himself by lowering the quality of the beer. If this is prevented by the force of competition, then the tendency will be for the tax to remain where it originally falls.

ECONOMIC EFFECTS OF TAXATION. Since all taxation must be met out of the national dividend—the aggregate of values produced by the industry and commerce of a country—it is evident that nothing should be done by way of taxation which is likely to impair the productive efficiency of the nation. Taxation, from the standpoint of the business community, is always regarded in the light of a burden, largely because there is no direct connection between the amount contributed in taxation and the services received by the individual. This view has also gained ground owing to the heavy increase in the national budgets of most of the great powers in modern times. Now it is a characteristic of most people, that they feel themselves more competent to spend their own resources to the best advantage than any outside authority, so that they are naturally prone to resist any transference of wealth from themselves, even though they may be assured that it is to their ultimate advantage. Yet we must not allow ourselves to lose the sense of perspective since business men at all times and in all conditions have spoken strongly against this "intolerable burden." In 1907 an income tax of 1s in the pound was regarded as economically unsound, yet were the present tax to be reduced to a sum double

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this amount it would be hailed as a great relief—at all events until the novelty had worn off. Hence, whilst admitting that heavy taxation can, and will, cripple industry, we must recognize that hasty generalizations, based primarily on the size of the national budget, may be very misleading.

A question which is frequently raised is the effect which direct taxation exercises on the incentive to work. The minority report of the Committee on National Debt and Taxation comments on the conflicting evidence of witnesses on this point. There are those who maintain that excessive taxation destroys the incentive to work, whilst others contend that it serves as a stimulus to those who wish to avoid an unwelcome reduction in their standard of living. In this connection, however, it was pointed out that "the great mass of the national output of productive work comes from those whose incomes and property are either wholly, or almost wholly, below the level at which liability to direct taxation begins." Again, it is frequently alleged that heavy taxation discourages enterprise and initiative, in that it claims a substantial part of any profits which may be made, but does not allow losses incurred to be set off against them. From this it is argued that the general effect is to cause business men to prefer well-established and relatively safe enterprises to new and relatively risky ones, and that new developments will tend to languish. Yet, in the view of the minority report of the Committee on National Debt and Taxation, such a chain of reasoning can be accepted only with caution—

> Individuals make their choice between different uses for their capital according as they do or do not feel that the probable return obtainable compensates for the degree of risk which any particular investment entails. Anything which alters either the *relative* return obtainable from an industrial investment, or the *relative* degree of risk attaching to these alternatives, will influence the proportions in which capital is distributed between them. Thus any change in political or economic conditions which adds markedly to the risks of industrial enterprise without at the same time increasing the profits with which enterprise may expect to be rewarded, will discourage investment in industry, and to that extent create a preference for gilt-edged securities. Again, a special tax on fixed-interest stocks would increase the attractiveness of, and attract capital towards, industrial investments.

Yet, a cause which affects alike the returns from all classes of investment can scarcely cause much redistribution of resources. If the tax caused a disproportionate reduction in the yield from the

more speculative types of industrial investment, the above argument might be true, but where all are affected alike then any diversion of capital cannot be ascribed to this cause.

Again, when the burden of taxation is excessive, the net sums which business enterprises can place to reserve are reduced, since profits not distributed to shareholders are subject to income tax. The reserves which business enterprises thus accumulate form an extremely important addition to national capital Private saving, leading to the accumulation of capital, takes time, and there is always a certain amount of economic friction before it is invested in production. Indeed, it may never find useful employment at all, but be diverted to unsound speculation. Capital accumulated by way of business reserves is created in the place where it is required—"it is at the growing-point of industry, enabling new needs and opportunities to be met without delay as and when they arise. This is true of the new enterprising business, which may as yet be making only small profits, as well as of the established company whose ability to save large sums for development year by year has given proof of efficiency and power of continued expansion."[1] In so far as high taxation restricts the sums available for these purposes, it is detrimental to the soundness and prosperity of industry and trade.

Taxation may affect production by restricting the general volume of savings apart from company reserves. This result may be brought about both by diminishing the power to save and by undermining the will to save. The greatest effects on the capacity to save will tend to fall on the wealthier classes, from whom the bulk of the saving comes under the present system of the distribution of wealth. At the lower levels of income—say up to £500—a high proportion of the tax is probably paid out of funds which would otherwise be employed for consumption, and to this extent does not affect the volume of savings. In the case of incomes up to about £2,000, the Committee on National Debt and Taxation was of opinion that a heavy rate of income tax was likely to result in economy of consumption rather than in curtailment of savings, though the latter might occur in certain cases. They considered four examples, namely—

1. Where the individual makes no effort to save at all, but habitually spends up to the limit of his net income, and would equally do so with a lower tax.

[1] *Report of the Committee on National Debt and Taxation.*

2. Where the individual is committed to the payment of life assurance premiums, but would not save anything over and above those premiums, even if the tax were much lower.

3 Where the individual, without being committed in this way, has a high standard of saving, and reduces his living expenses in order that the income tax may cut into his savings as little as possible.

4 Where the individual aims at saving enough to produce a given net income after deduction of tax, and therefore tries to invest a larger gross sum than he would if the tax were lower.

With regard to the incentive to save, this is only undermined by heavy taxation when the strength of this incentive varies directly with the return obtainable. Such cases are relatively rare, for persons who save in order to provide against future contingencies will usually put forth greater efforts to save when the return is likely to be less. The whole matter is essentially psychological, so that different people will naturally react in different ways. Less saving, however, implies less new capital available for investment, so that those industries in need of new capital for expansion as well as those which supply capital equipment must be adversely affected.

Summing up, we may infer from this very brief examination that the effects of taxation upon production are difficult to assess, and that easy generalizations, which are only too frequently made, can be extremely misleading. As Dr. Dalton points out in *Public Finance*—

> If all the proceeds of taxation were spent on waste, which contributed nothing to economic welfare, then any check to production as a result of taxation would be a clear economic loss But if the proceeds of taxation are wisely spent, the stimulus to production due to this expenditure may be far stronger than the check to production due to taxation. Public finance, viewed as a whole, would then be responsible for increasing production.

There are many who maintain that a system of taxation should go beyond the mere raising of revenue, but should be employed as an instrument in the hands of governments for redressing the inequalities which exist between different sections of the community, or to achieve any other object of social control which is deemed to be desirable in public interest. Thus, heavy income tax and sur-tax may be deliberately imposed to bring about a redistribution of wealth among different sections of the community. The incomes of the well-to-do are diminished, whilst those of the poorer classes are

augmented, either directly by pensions and grants, or indirectly by the free provision of social services.

Possibly the most striking method of employing taxation to redress social inequality is in the case of death duties. The inequality of wealth and income is one of the most serious aspects of the system of private property, and there are many who consider that such inequalities might well be reduced by a wider application of steeply-graduated taxes on accumulated wealth. As Professor Clay points out, the inequality which arises from inheritance must be distinguished from that resulting from differences in the natural capacity of the individual.

> The latter has some economic justification; large rewards are possibly needed to induce people to make the effort and sustain the anxieties which modern industry requires in its higher direction . . . But this association is severed when the man who made the business dies. The property his heirs enjoy is not an incentive to effort on their part, but rather a discouragement. The economic grounds on which the right to *accumulate* property rests, therefore, afford no justification for the right to *inherit* property.[1]

Proposals to adjust such inequalities by taxation have naturally encountered resistance, not only from vested interests, but also from those who are alarmed at the injurious complications which are likely to arise. A point often brought forward is the effect on saving and on the accumulation of capital. As the Committee on National Debt and Taxation has shown, estate duty must be met out of capital so that a sale of some portion of the estate must be made to someone having liquid funds available for investment. This means that money, which might have flowed into new investments and created new capital has been absorbed into old investments. The immediate effects are twofold—

1. While there is no destruction of existing capital there is a change of ownership.
2. Potential new capital, to the full amount of the duty, is prevented from coming into being.

In this connection, too, we may note the various attempts which have been made at the taxation of a surplus, that is, of that portion of income or of capital value which is not the result of any useful economic effort on the part of the recipient. Thus, in the United

[1] *The Problem of Industrial Relations.*

States, property in the neighbourhood of cities is subject to betterment charges. A share of the surplus value in the land which follows from such a circumstance as the development of a large city is appropriated by the State through taxation. Obviously the property owner has done little, if anything, to create this extra value, so that it is only equitable that he should be made to give up part of the value which the community has created for itself. Even here the subject presents great practical difficulties, such as the valuation of a fair return to the capital which the owner has actually invested in the property.

SPECIAL TAXES AND THEIR INCIDENCE. We have briefly reviewed the general principles of the incidence and effects of taxation; we shall now examine the characteristics of a few of the most important taxes.

1. Land Tax. Taxes on land appear to be in almost universal use, and are found at all periods of history. The general tendency is for such taxes to fall on the owner of the land. It is true that, if the land is leased to a tenant, the owner would be willing to attempt to shift the tax by charging a higher rent for the land. If, however, the owner is already receiving the full economic rent of the land, then the tenant will be unable to pay more and still make cultivation worth while. It is only if an amount less than the true economic rent is being charged that a land tax will be shifted. Again, as between the present owner and a future purchaser of a piece of land, there is a tendency for the tax to be borne by the former, since the tax will tend to be absorbed in the lower capital value which the land will yield after the imposition of the tax. In other words, the tax burden will be discounted by the new owner by his offering a lower price for the land, always provided that there are open to him other types of investment less heavily taxed

2. Income Tax. Despite many arguments to the contrary, it would appear to be fairly certain that the burden of the income tax tends to stay where it is levied. It has been argued that traders try to shift the tax on to consumers by adding it to the prices of the commodities which they sell. Yet, as Professor Pigou told the Committee on National Debt and Taxation, the tax "is assessed on the profits resulting from trade and industry, and if, as may be presumed, people are already charging the prices that yield them the

best profit, the removal by the State of a portion of the profit will not tempt them to fix prices differently." Should the income tax cut too deeply into the return considered necessary to maintain the conventional standard of living, then the individual may attempt to shift it by seeking an advance in salary. This is scarcely likely to be successful, however, unless the individual happens to be in an especially favourable position In the case of a limited company, there is much less motive for any attempt to shift the tax. A company, in making a distribution of profits, recoups itself by a deduction of tax from its shareholders, and is not in the least interested in the fluctuation of their individual liability. Hence, to this extent, the rate of tax is a matter of indifference to the company, and in consequence it has but little inducement to raise its prices on account of an increase in the rate of tax.

3. Estate Duty. Many controversies have arisen over this tax and its effects. It is usually considered that the tax is levied on the transfer of property, rather than on the property that is transferred. Gladstone justified the tax on the ground that, "carrying property in perfect security over the great barrier which death places between man and man is perhaps the very highest achievement, the most signal proof of the power of civilized institutions. . . .I conceive nothing more rational than that, if taxes are to be raised at all, the State shall be at liberty to step in and take from him who is thenceforward to enjoy the whole in security that portion which may be *bona fide* necessary for the public purpose " The incidence of the death duties is not uniform as between the testator and those who benefit under his will. If, for example, the testator deliberately curtails his expenditure during his lifetime with a view to making provision for the taxation which he knows will fall upon his estate after his death, then undoubtedly the incidence of the tax is upon him. If the testator makes no such provision, then the full incidence of the tax is upon the successor. The matter cannot easily be settled, for, as the Committee on National Debt and Taxation has said—

In favour of the view that the duty is on the successor it may be pointed out that it is not paid by the predecessor, that there is no liability till he dies, and that he is free to ignore the duty if he wishes, while the successor, as a hard matter of fact, comes into so much less than he would have done, and has no kind of redress

On the other side it may be answered that the subject of taxation is,

after all, the property which has been held or accumulated by the deceased, and that the tax has fallen upon him, in the sense that it has affected the amount of which he could dispose.

4. Stamp Duties. These duties were first imposed in 1694, and required that certain documents had to be written on stamped paper The revenue was to be protected against any evasion by the fact that documents could not be given in evidence in any Court unless they were properly stamped. These taxes do not constitute a scientific type of taxation, since their incidence is by no means clear, they have no particular relation to ability to pay, and they tend to hamper business transactions. The stamp duties on stocks and shares are said to reduce Stock Exchange transactions and to obstruct investment in the class of securities subject to the tax. The companies' capital duty, again, may operate as a bar to the flotation of new companies, though its influence in this respect does not appear to be very obvious. The incidence of the duty tends to fall on the company, and not to be passed on to the consumer. Again, in the case of the stamp duty on cheques, the incidence is upon the person drawing the cheque, unless he can pass it on in the course of the business transaction It has been argued that if this duty were to be reduced, cheques would be employed much more freely in the settlement of business transactions, but it appears doubtful whether much would be gained from such a course.

5. Excise Duties. The British excise system was adopted in 1643 to raise money for the conduct of the Civil War. The system became a permanent one, and finally came to include a variety of taxes. Modern experience has shown that excise duties on beverages and tobacco products are the most productive and elastic. The excise duties are indirect taxes which are intended to be, and are, passed on to the consumer. The taxes on alcoholic beverages, which form an important part of the British excise duties, have pressed heavily upon the working classes in the post-war period. Yet it would be a big mistake to attribute the whole of the diminution of consumption to taxation. The restrictions which were in force during the War period, taken in conjunction with the industrial depression and unemployment which have prevailed since, have persisted long enough to cause changes in the habits of the people.

THE BUDGET. The term "Budget" was first adopted in England

in 1763 to denote an annual statement of expenditure and revenue prepared by the public authority. The Budget is in reality a public balance sheet which constitutes a legislative Act authorizing the expenditure of a certain sum. The term also implies a particular method of managing the finances which will receive the consent of a representative body. The first step is to give an approximate idea of what will be the expenditure. Budgets are always framed in advance. One of the main objects of the study of the financial

THE NATION'S BALANCE SHEET

I. ORDINARY REVENUE AND EXPENDITURE, 1932-33

Estimated Revenue	£ Mil.
Inland Revenue—	
Income Tax	260·0
Surtax	66·0
Estate Duties	76·0
Stamps	23·0
Excess Profits Duty, Corporation Profits Tax	1·2
Land Tax, etc.	0·8
Total Inland Revenue	427·0
Customs and Excise—	
Customs	174·6
Excise	125·4
Total Customs and Excise	300·0
Motor Vehicle Duties—	
Exchequer Share	5·0
Total Receipts from Taxes	732·0
Post Office Net Receipts	11·7
Crown Lands	1·2
Receipts from Sundry Loans due to British Government	4·4
Miscellaneous	17·5
Non-tax Receipts	34·8
Total 1932 Revenue	766·8

Estimated Expenditure	£ Mil.
Interest and Management of National Debt	276·0
Payments to Northern Ireland Exchequer	6·8
Miscellaneous Consolidated Fund Services	3·5
Total	286·3
Supply Services	
Defence—	
Army	36·5
Navy	50·5
Air Force	17·4
Total	104·4
Civil—	
I. Central Government and Finance	2·0
II. Foreign and Imperial	4·8
III. Home Department, Law, and Justice	15·5
IV. Education	52·0
V. Health, Labour, Insurance (including Old Age and Widows' Pensions)	141·3
VI. Trade and Industry	11·1
VII. Works, Stationery, etc.	8·6
VIII. War Pensions and Civil Pensions	49·9
IX. Exchequer Contributions to Local Revenues	45·0
Total	330·2
Tax Collection—	
Customs and Excise and Inland Revenue Votes (including Pensions £944,000)	12·6
Total 1932 Expenditure	733·5
National Debt-sinking Fund	32·5
Surplus	0·8
	766·8

II. SELF-BALANCING REVENUE AND EXPENDITURE

	£ Mil.
Post Office	59·2
Road Fund	22·9
Total	82·1

position is to maintain legislative control, and this can be effected only if proper consent is obtained before the expenditure is incurred.

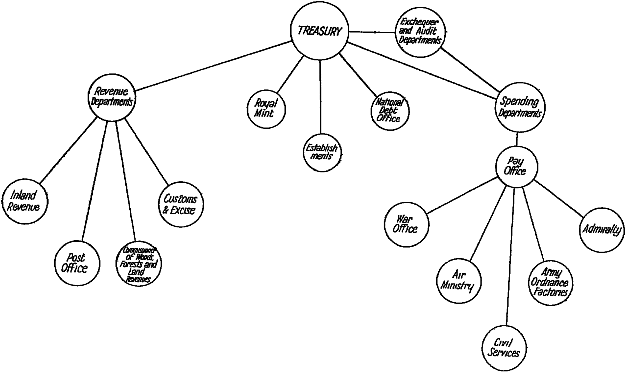
In the financial administration of the State, as in the case of all other classes of public business, we may recognize two functions—the legislative and the executive. The legislature must determine in what directions the expenditure of public funds is to be incurred, and by what means the necessary revenue is to be raised. As opposed to this, the executive must carry these plans into operation; it must raise the required funds from the stipulated sources and apply them in the prescribed manner. At the head of the executive is the Crown, that is, in practice, its constitutional ministers who are responsible to Parliament. Hence, under present conditions, the true head of the financial administration is the Cabinet, although in practice the greatest responsiblity appears to rest upon the Chancellor of the Exchequer. It has been suggested that the responsibility should be distributed—

> At present the Chancellor of the Exchequer seems alone among his colleagues to be regarded as charged with responsibility for financial policy. While no doubt he is able to enlist some support within the Cabinet, no organized machinery exists whereby he can be assisted in his difficult task. We suggest that on the analogy of the Committee of Imperial Defence, which is working successfully to secure full co-ordination in matters affecting the national defence, there should be a standing Finance Committee of the Cabinet, which would be kept fully informed of the state of national revenue and expenditure, and would examine all schemes submitted to the Cabinet, which involved serious outlay, not merely on their individual merits, but from the wider point of view of their bearing on national finance [1]

Beneath the Cabinet comes the Treasury, which is the permanent Government department entrusted with the duty of exercising general control over the whole financial administration. The Treasury exercises direct control over the two great revenue-collecting departments—the Inland Revenue and the Customs and Excise. It also maintains close contact with the spending departments, the principal of which are the War Office and the Admiralty. The spending departments do not, however, make their own payments, but this work is performed on their behalf by the Pay Office, the nominal head of which is the Paymaster-General. When the money

[1] *Report of the Committee on National Expenditure, Cmd.* 3920

FINANCIAL ORGANIZATION OF THE STATE



has been spent, the Appropriation Accounts, showing how it has been utilized, are audited by the Auditor-General, who reports upon them to the Public Accounts Committee of the House of Commons.

The first step in the financial arrangements of the year is the preparation of estimates of the expenditure to be met. These are prepared in the light of almost continuous discussions between the Treasury and the officials of the various spending departments. In the estimates, the various services are classified in groups, called *votes*, because each group is the subject of a special vote in the House of Commons. In Parliament, the first step in financial business is the introduction of the estimates, which are, in reality, the executives' demands for authority to spend the sums specified. For this purpose, the House resolves itself into a Committee of Supply, when each service is taken in turn, and a general statement is made by the responsible minister on the whole of the estimate, followed by a full debate. In order to raise the revenue necessary to cover this expenditure the House resolves itself into a Committee of Ways and Means, whose business it is to discuss the proposals of the Chancellor of the Exechequer for the provision of funds. The bulk of the revenue is raised under the authority of permanent statutes, but the income tax and tea duty need annual re-enactment. Hence, apart from changes in permanent taxation, this constitutes the principal task of the Committee of Ways and Means.

THE NATIONAL DEBT. As we have already seen, cases not infrequently arise when Governments are compelled to incur expenditure on such a scale that they cannot hope to provide the necessary funds from current taxation. In consequence they are compelled to use the credit of the State for the purpose of borrowing the money which they require. Public debts have shown an astonishing increase in recent years—"so general and so large are they in advanced communities that thev have come to be regarded as almost a mark of progressive civilization."[1] We have said that the State may use the public credit for the purpose of borrowing, but it may also use its powers of compulsion to cause the citizens to lend funds in the same way as it levies taxation upon them. Such a procedure does not amount to confiscation, for there may be an obligation to pay a

[1] G Armitage-Smith, *Principles and Methods of Taxation.*

certain rate of interest and to repay the principal sum. Such a proceeding obviously imposes injustice and hardship upon the members of the community affected since, whereas in the case of a voluntary loan, every person contributes according to his available means, in the case of a compulsory loan persons are forced to advance funds which they require for other purposes In no case, of course, can the State take more than a man possesses, but it may compel him to liquidate resources to make the payment in such a way as to cause loss to himself and to the community as a whole.

GROWTH OF THE BRITISH NATIONAL DEBT

Date	Event	Amount (£ millions)
1688	Accession of William and Mary	1
1694	Foundation of the Bank of England	1·2
1697	Peace of Ryswick	21·5
1702	Death of William III	16 4
1713	Treaty of Utrecht	53·7
1749	Spanish-Austrian Wars	80
1763	End of Seven Years War	138
1783	End of War of American Independence	238
1802	Treaty of Amiens	537
1815	Waterloo	876
1854	Outbreak of Crimean War	808
1857	End of Crimean War	838
1899	Outbreak of Boer War	627
1903	End of Boer War	770
1914	Outbreak of Great War	649
1919	End of Great War	7481
1932		7423

In dealing with the National Debt, we may note that it assumes a number of different forms. First we have the *Funded Debt*, which includes perpetual annuities, that is, those loans which have no fixed date for repayment. In this country, however, no debt is perpetual in the sense that it cannot be repaid, since in every case the Government has reserved an option to repay on or after a fixed date upon the terms laid down at the time of the loan issue. A second part of the National Debt is the *Terminable Annuities*, which consist almost entirely of the liability of the National Debt Commissioners to the public in respect of annuities sold for life and for terms of years. Finally, in the third category of the *Floating Debt*

we have those loans which are redeemable at a definite date, with or without an option to repay at an earlier date. This debt includes Treasury Bills and Ways and Means Advances. The influence which this latter form of debt can exert on the economic system has already been discussed in the chapter on the Money Market.

When necessity compels Governments to borrow, the true path of financial wisdom lies in repaying the debt at the earliest possible moment. *It is in this way only that it is possible effectively to safeguard public credit.*

When a nation goes about to borrow, the security which it offers as a pledge to the lender is its taxable capacity The more debt it has outstanding, the more that capacity is burdened to pay interest, and the less security has the nation left to pledge when it needs a fresh loan Crises will come, wars and great social reforms, when loans are necessary. Were a nation to make no effort to pay off its debts during the peaceful intervals between the crises, it would find at each crisis that, with less security left to pledge, it had greater difficulty in borrowing, until at last its credit would have become exhausted, and it would fall into ruin and bankruptcy [1]

The British practice is to provide in the Budget a fixed sum to be set apart annually for the payment of interest on the debt, and as a sinking fund for the redemption of part of the principal. Unfortunately, the existence of such a fund offers a keen temptation to a Chancellor who is hard-pressed for funds to balance his budget without resorting to new taxation, and "raids" on the sinking fund have been too frequent. In certain cases, specific sinking funds have been created for redemption as one of the conditions of a loan, so that the fund cannot be touched without a breach of the agreement. This may lead to the equally undesirable expedient of new borrowing in case of need.

TEST PAPER 14

1. How would you understand the expression "Functions of Government"? Explain why or why not you would regard the carriage of letters by post as one of those functions.
2. In what essential respects do public debts (*a*) resemble, (*b*) differ from, private debts?
3. "It is the business of the Government to govern and not to trade." Do you agree? Give reasons for your answer
4. How far is it possible to frame abstract rules regulating public expenditure? Give a classification of the objects of Government expenditure.

[1] E. Hilton Young, *The System of National Finance.*

5 How should a State meet its expenditure? Contrast, if you can, the requirements of war time and peace time.
6 What are the main items of national expenditure in this country? Why is it so difficult to reduce the amount spent by the State?
7. If a Government wished to raise a loan of £50,000,000, mention two methods it might adopt and explain which of these you would approve and why.
8. What arrangements are usually made for the repayment of State loans?
9 What are the main sources of revenue of the British Government? Indicate the chief changes in these sources made during the last century and account for them
10. Draw the diagram on page 346 and explain its meaning

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